

QUARTERLY HEARINGS ON THE CONDUCT OF MONETARY POLICY

HEARINGS BEFORE THE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS HOUSE OF REPRESENTATIVES NINETY-FIFTH CONGRESS SECOND SESSION

PURSUANT TO THE FEDERAL RESERVE REFORM ACT OF 1977
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QUARTERLY HEARINGS ON THE CONDUCT OF MONETARY POLICY

FRIDAY, JULY 28, 1978

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, D.C.

The committee met, pursuant to notice, at 9 a.m., in room 2128, Rayburn House Office Building, Hon. Henry S. Reuss (chairman of the committee), presiding.

Present: Representatives: Reuss, Moorhead, Minish, Hanley, Mitchell, Neal, Blanchard, Derrick, Hannaford, Lundine, Cavanaugh, Oakar, Stanton, Wylie, Rousselot, Hansen, Grassley, Fenwick, Leach, Steers, and Green.

The CHAIRMAN. Good morning.

The House Committee on Banking, Finance and Urban Affairs will be in order for its quarterly hearings into the conduct of monetary policy.

Chairman Miller, we welcome you for the second time in 2 days before this committee. Our topic today, as in your first appearance before us on March 9, 1978, is the conduct of monetary policy.

At the time of that occasion 4 months ago, just 1 day following your swearing in, doubts were still being expressed now and again about your personal qualifications, experience and ability to take charge in this complex and, to you, relatively novel policy area.

No such doubts now remain. To your credit, yours is a voice which is listened to with respect on topics whose depths you must hardly have been aware of only a short time ago.

Whether the institution that you head, the Federal Reserve System, has learned as much as you have or as quickly is another question. I am not inclined to share the alternating panics about impending inflation or impending recession that seem to be a regular feature of public commentary on economic questions.

Nevertheless, it is reasonable to say that we are entering a period of relatively high policy risk—risk that error on the side of either restriction or expansion could trigger a damaging breakdown of the present *modus vivendi*—a new recession or an accelerated inflation.

The Federal Reserve has shown a very disturbing tendency in the past to make such errors just when the potential consequences are the worse.

You are familiar with this history, and I will not recite it to you in detail. It was in part expansionary recklessness at the Federal Reserve in 1972, coupled with the fiscal recklessness of the administration, and the Congress, that put the economy into overdrive

and made it especially vulnerable to the Arab oil embargo of the following year.

It was a contractionary spasm in late 1974, money growth falling close to zero, driving interest rates to virtually unprecedented levels that made the recession of 1974-75 the deepest since the thirties.

As Prof. Otto Eckstein recently put it,

It should be recalled that there is not a single instance of success in raising interest rates to moderate the economy without creating a major disturbance. The Federal Reserve has carried the policy too far every single time.

At the moment, the thin line which the Federal Reserve must follow is becoming thinner. Unemployment has fallen far more rapidly than anticipated, leading many, myself included, to the belief that it is time to deemphasize macroeconomic fiscal stimulus in favor of specific targeted programs—public service employment, wage subsidies in jobs with substantial training components, and targeted low interest credit—designed to attack the remaining intolerable unemployment rates among minorities and youth.

At the same time, inflation appears to be picking up. Here, however, I caution that our perceptions of inflation are often distorted by the sharp seasonality of food prices.

We may be overrating inflation now. We may underestimate it later. In any case, the preconditions for tight labor markets in certain skill categories, and for attempts by powerful corporations to widen profit margins are both clearly present.

What has the Federal Reserve been up to under these circumstances? Two separate issues need to be discussed.

One, the Federal Reserve's targets for the growth of M_1 have been and continue to be unrealistic and should be raised.

Somewhere in the past, money growth got off the track laid down by former Chairman Arthur Burns. As a result, for 1 full year now M_1 growth has consistently come in above the target range announced four quarters before.

This is, frankly, ludicrous. How can we in Congress place any credence in targets that the Federal Reserve consistently fails to achieve? We cannot.

It would seem a simple matter for the Federal Reserve to reestimate the expected growth of the money stock in each of the next four quarters, to admit that a forecasting error was made, and to present corrected estimates that one and all could accept as realistic.

If that included a reevaluation of M_2 and M_3 , which have assumed a new importance, so much the better.

For example, to meet the target for monetary growth established for the third quarter of this year, money growth would have to be 2.8 percent at an annual rate between the second and third quarter.

To meet the target range prescribed for the fourth quarter, money growth would have to be 5.2 percent at an annual rate from the second to the fourth quarter. Neither you nor I expect this to happen. Why not revise the forecast?

Two, in the past 6 months rates of growth of all three monetary aggregates have been falling. Interest rates have been rising sharp-

ly. Is the Federal Reserve at the beginning of yet another recessionary roller coaster?

The rate of growth of the narrowly defined money stock has fallen slightly, from 8 percent in the last two quarters of last year to 7.8 percent in the first two quarters of this year.

M₂—money plus time and savings accounts excluding CD's at banks—has fallen even more sharply, from an annual growth rate of 9.2 percent in the last half of 1977 to 7.8 percent in the first half of 1978.

The decline in the growth rate of M₃, which includes deposits in nonbank thrifts, has been most precipitous of all, from 11.8 percent in the last half of 1977 to 8.1 percent in the first half of 1978.

M₃ includes the funds available for our Nation's housing industry. You projected 4 months ago that the growth of this aggregate would slow, and at that time I objected, saying, "Of all the dogs that do not deserve to be kicked around, it is the housing one."

But this particular dog has been kicked particularly hard in the past 6 months. With the coming to maturity of the new baby boom of a generation ago, this has been obscured.

But the fact is that the interest rate available on new mortgages, after having been stable for almost 4 years at near 9 percent, has risen 37 basis points from December to July. It now stands at 9.46.

The consequences for new housing construction cannot be far behind; indeed, they must be being felt already.

Short-term interest rates have also risen sharply in the past 6 months. The average rate on 6-month Treasury bills was 7.3 percent in June, up 53 basis points from January, and only 1.9 percentage points below the peak levels of 1974.

This is despite the excellent advice you received as long ago as March 7, 1978, in testimony before this committee from Prof. Rudiger Dornbusch, MIT, to wit: "Interest rates should not be allowed to rise further and, indeed, a rollback is desirable."

At various times in the intervening period, you have hinted to the administration that you would, in effect, trade a less restrictive monetary posture for a tighter fiscal one, that you would endeavor to hold interest rates to reasonable levels if the budget deficit were to be significantly reduced.

As you know, I strongly support this concept. But I am afraid I don't see it at work. The administration has, to be sure, performed honorably in taking up a suggestion I made as long ago as last December and cutting back on its proposed tax reduction package, a suggestion the general outlines of which I believe you joined.

But each time this is raised with you, as it was by Congressman Patterson at yesterday's hearing, the answer is not now, maybe next month. When do you think we can begin to see some reciprocation from the Federal Reserve on this issue?

The upshot of these circumstances and events—unrealistic monetary targets, slowing money growth rates, and rising interest rates—has been a substantial increase in fears that the Federal Reserve will repeat the disastrous cycle of 1973 to 1974—high interest rates, near zero money growth, and a new recession which will fail to cure inflation just as surely as the last one did.

A simple statement of intent on your part would dispel this uncertainty. Let me ask you bluntly, do you or do you not support

the President on his basic refusal to increase unemployment to fight inflation?

Welcome, Chairman Miller. I hope in the course of your testimony you will be able to give us some direct answers to the question.

STATEMENT OF HON. G. WILLIAM MILLER, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. MILLER. Thank you very much, Mr. Chairman.

I am pleased to have the honor of appearing before this committee 2 days in a row.

In the course of my remarks, I hope to address the questions you have asked in your opening statement. To the extent that my prepared statement leaves those questions unanswered, I hope we can come back to them and deal with them more specifically.

Mr. Chairman and distinguished members of the committee, with your permission I would like to submit my prepared statement for the record and perhaps hit its high points so that we can proceed to open up this session for questions.

The CHAIRMAN. Without objection, not only your prepared statement, but I think you have a number of supplementary charts, which will be received for the record.

Mr. MILLER. Let me just try to hit the high points. The current expansion is now in its fourth year. There has only been one expansion in the postwar period—that beginning in 1961—which has lasted significantly longer.

It is a very durable expansion, and it has been well sustained so far this year, as you can see by looking at chart 1, which deals with real GNP, total employment, and the rate of unemployment which has shown a continuing drop.

Especially encouraging has been the performance of the labor market. Payrolls have swelled by more than 2 million workers since last December. The overall unemployment rate has dropped below 6 percent, and the rate for heads of households is now 3.6 percent. Joblessness among youths and minorities remains disturbingly high, although improved employment opportunities have existed for these groups in recent months.

Hiring in such large numbers suggests that businessmen are looking forward to further growth in production. Economic indicators generally point in that direction. If you look at chart 2, you will see that buying sentiment is still relatively high, and consumer spending should continue to rise.

In the business sector, cautious inventory management has kept stocks in good balance in most sectors. Rising sales are therefore likely to prompt further advances in inventory investment. Various surveys of business intentions—as well as data on equipment orders and construction contracts, which are plotted in chart 3—suggest that moderate increases in capital spending will continue in the months ahead.

In addition, our net export balance has begun to improve. Imports are likely to rise less rapidly during the next year. Exports should pick up if activity abroad increases as expected, and as changes in the money exchange rates which have occurred since last fall begin to take effect and improve the competitive position of U.S. goods.

The increase in housing starts last month, Mr. Chairman, suggests that construction activity will remain at a high level over the near term, but it appears likely that building will begin to taper off later this year. Growth in State and local government expenditures should probably be modest, in light of the increasing pressure for restraint in public spending.

On balance, the various indicators of spending and activity suggest that the current expansion will continue in the year ahead. As an expansion matures, however, growth can be expected to moderate. I think it likely that over the next four quarters real GNP will grow in the range of $3\frac{1}{4}$ to $3\frac{3}{4}$ percent. Such a pace should be adequate to keep unemployment from rising. During the second quarter of 1979, the unemployment rate may average in the $5\frac{3}{4}$ - to 6-percent range.

As an expansion continues there is also danger of developing imbalances. The greatest threat lies in accelerating inflation. If you look at chart 4 you will see that price increases have stepped up sharply so far this year. Through May, consumer prices rose at an annual rate in excess of 10 percent. The CPI reported this morning shows a continuation of that trend. Much of the surge is attributable to adverse developments in the volatile agricultural sector, but the prices of other goods and services also have been rising briskly and the advance in unit labor costs has accelerated. My best guess is that during the four quarters ahead prices in general will rise on the average of 7 to $7\frac{3}{4}$ percent.

As we move into a period of heavy collective bargaining, which will begin to pick up in the next year, the intensified inflation we have been experiencing and the greater tautness of labor markets could be reflected in higher wage demands. These costs will be boosted early next year by additional mandated increases in social security taxes and in the minimum wage. The continued interplay of wage and price rises, coupled with the legislated cost increases, will make it difficult to achieve much relief from underlying inflationary pressures over the next year.

The strong momentum of inflation must be a central consideration for Government policymakers today. Unless we soon contain the accelerating advance of prices, the result will be increasing economic disruption and distortion, ending in all probability in serious recession.

Monetary policy has been and will continue to be designed to restrain inflation, but monetary policy cannot do the job alone. Placing too heavy a burden on monetary policy will entail dangers of severe financial dislocation that could have unfortunate long-term consequences for the domestic and international economies.

Financial markets have already begun to show strains. Debt burdens for household and businesses have grown tremendously. Financial institutions have experienced declining liquidity as they have attempted to accommodate heavy loan demands. This has been reflected in the upward part of interest rates since the spring of 1977. If you look at chart 5, you will see the pattern of interest rates since 1974.

The willingness of households to go heavily into debt at relatively high interest rates in some degree reflects a feeling that it is best to buy now before prices rise still further. This sentiment

seems to have played an important role in the burst of sales of automobiles and other consumer durables during the first half of 1978. If you look at chart 6, you will see that the volume of consumer and mortgage credit has been growing rapidly, and so has the ratio of debt repayment obligations to disposable personal income. Both have reached unprecedented heights. This situation bears careful watching.

Also, there is a declining level of corporate liquidity. Internal funds of businesses have fallen short of sums needed for investment in inventories and fixed capital. The result has been a rising volume of borrowing; balance sheet ratios have deteriorated since late 1976. Chart 7 shows that phenomenon.

On top of these private credit demands have come sizable public demands. In financing the Federal budget deficit, the Treasury has competed actively with the private sector for credit and has added to the general upward pressure on interest rates.

During the early stages of economic recovery, commercial banks and thrift institutions were able to satisfy loan demands, but in the past year there has been a fairly steady decline in liquidity ratios of these institutions.

The Federal Reserve might have attempted to alleviate some of the liquidity pressures in the economy by aggressively providing bank reserves and money. But at best this would have offered no more than a temporary palliative, and it would have set the stage for an explosion of monetary expansion and exacerbated our problems of inflation.

As it is, since early 1977 there has been a rather persistent tendency for growth in the narrow money stock— M_1 —to run above the ranges the System has established, as you pointed out Mr. Chairman. Over the past four quarters, M_1 —which includes only currency and demand deposits—has increased at 7.9 percent. If you look at chart 8, and you will see that this was well above the 4 to 6.5 percent range reported to this committee a year ago. Chart 8 compares the ranges established by the Federal Reserve over time with the actual growth in M_1 . Going back through that series, you will see that we have been rather consistently experiencing growth in M_1 above the ranges.

Over the same four quarters, however, the broader monetary aggregates— M_2 and M_3 —recorded net increases that were well within their announced ranges. Chart 9 depicts M_2 . A chart for M_3 would be similar, but we did not want to burden you with too many charts.

The fact that growth rates of M_2 and M_3 remained within their ranges over the past year, while M_1 growth was strong, is attributable to the slowing in expansion of interest bearing components of the broader aggregates. A year ago yields on short-term market debt instruments were below those that depository institutions are permitted to pay on savings and small denomination time deposits. But as market rates rose, they surpassed the regulatory ceilings, prompting many savers to divert funds from deposits into Treasury securities, money market mutual funds and other higher yielding instruments.

To help preserve the competitiveness of depository institutions—and thus to avoid the distortion of credit flows that might occur if

these intermediaries were unable to accommodate borrowers who do not have access to open market sources of funds—the Federal regulatory agencies created two new deposit categories, effective June 1.

One is an 8-year time deposit. The other is a 6-month time deposit whose ceiling rate is determined by the results of the most recent weekly auction of 6-month Treasury bills.

A noticeable pickup in inflows to savings and small time deposits in June is evidence of the success of depository institutions in exploiting these new certificates. An estimated \$8.5 billion of new 6-month instruments was issued in June alone, and growth has continued at a brisk pace.

The latest figures showing a very substantial increase of flow of funds to thrift institutions indicates, Mr. Chairman, that we have reversed the trend that you mentioned; there is now a sufficient flow of funds to support continuing activity in the housing industry.

The Federal Open Market Committee at its meeting last week considered carefully these recent patterns in monetary expansion, as well as the prospects for the economy, in deciding on the appropriate longer ranges for the monetary aggregates. While members of the Committee differed somewhat in their appraisal of the outlook, there was a broad consensus that inflationary pressures will remain strong in the year ahead. It is critical that macroeconomic policy be conducted most prudently at this juncture to assure that economic expansion continues at an appropriate pace without fueling the already unacceptable intensity of inflationary pressure.

Growth ranges for the monetary aggregates selected by the FOMC for the year ending with the second quarter of 1979 are identical to those announced 3 months ago. The range for M_1 is 4 to 6.5 percent; for M_2 , 6.5 to 9 percent; and for M_3 , 7.5 to 10 percent. The growth range for bank credit, however, was raised to 8.5 to 11.5 percent in recognition of the greater share of borrower demands being directed toward banks.

The Committee discussed at some length arguments in favor of raising the upper limit of the range for M_1 , Mr. Chairman, along the lines you suggested. A major part of the discussion focused on the question of whether the persistent tendency over recent quarters for M_1 growth on average to overshoot the FOMC's longer-run range represented a fundamental shift in the demand for M_1 relative to GNP that should be accommodated. The Committee concluded that an upward adjustment in the range at this time would be undesirable in the light of continuing inflationary pressures. Nonetheless, it was recognized that in light of the recent behavior of money demand, growth in this aggregate over the year ahead might well be around its upper limit.

Let me depart from my prepared statement to say, Mr. Chairman, that we agree that it is not likely that M_1 will be brought back into the ranges previously set. So I would point out that the figures we are looking at now are for the four quarters ahead; we are not trying to bring the money supply in the fourth quarter back into the range set earlier this year. It is in that context—looking ahead four quarters—that the Committee felt that raising the upper limit would probably not be necessary at this point.

Scheduled regulatory changes could lead to a lower measured growth in M_1 , for example. Once the new regulation allowing automatic transfer of funds from savings to checking account goes into effect this coming November, the public can be expected to economize more on demand balances and to shift some funds from demand to savings deposits. This would tend to reduce the growth of M_1 .

But the extent to which a shift in funds will occur over the year ahead is uncertain, and so it really is difficult to decide how to adjust for this. In the transition period, therefore, M_1 will become a less reliable indicator, and we need to take account of that as we look at figures in the coming quarters. We need to have a new benchmark based on how shifts from demand to savings deposits occur.

The broader monetary aggregates are not likely to be affected significantly by the automatic transfer regulation. They are expected to grow well within their current ranges in the months ahead—as they have in the past—with growth sustained in part by the availability of the new certificate accounts. Thus, a generally ample flow of funds through banks and thrift institutions can be expected.

There are always great uncertainties surrounding monetary projections, but the FOMC believes that these ranges for the four quarters ahead are consistent with further moderate expansion of economic activity.

Of course, the FOMC's ranges are predicated on the proposition that there will not be a recession, and that the Federal Reserve will not take action to contribute to a recession but rather will try to maintain moderate economic expansion.

Unfortunately, the committee does not expect a diminution of inflationary pressure over the coming year. A reduction in the rate of price advance will require more time if it is to be accomplished in an orderly manner.

The inflationary biases—regulatory, legislated, and expectational—prevented the committee from taking a further step at this time toward the lowering of the monetary growth ranges—a process that must continue over time if the Nation is to achieve reasonable price stability. Under current circumstances, continuation of the present growth ranges for the aggregate implies a continued posture of restraint against inflationary pressures and probably involves some additional but tolerable liquidity pressure on financial intermediaries.

This underscores the limitations of monetary policy as the main bulwark against inflation. We need to mount a broad attack on the economic problems we face. A significant reduction in the Federal budget deficit would be an important first step in reducing inflationary pressures. But a longer range effort to treat the structural problem of inflation also is necessary.

We must reshape our tax laws to make certain that there are adequate incentives for savings and investment. The Nation has for many years now devoted too large a portion of its production to consumption and too small a share to the expansion and modernization of its industrial plant.

As a result, productivity growth has languished, with serious consequences for inflationary trends and for our standard of living.

We must take steps as well to bolster our position in international trade and thereby to strengthen the dollar. We should continue to seek freer access to world markets and attempt to make American businessmen more aware of opportunities for sales abroad.

We must seek ways of training and placing those individuals who, because of lack of skills or limited knowledge of employment opportunities, are not readily absorbed into the work force.

We must remove the impediments to competition, relieve the undue regulatory burdens, and avoid the costly governmental actions that have contributed importantly to inflationary pressures in recent years.

It is important to take strong measures now to curb inflation. With the continued cooperation of the administration, the Congress, the Federal Reserve, and the private sectors of the economy, I personally believe that we can, within the next several years, establish an economic environment which is conducive to full employment with price stability.

Thank you, Mr. Chairman.

[Mr. Miller's prepared statement on behalf of the Federal Reserve System follows:]

SEMI-ANNUAL REPORT ON MONETARY POLICY

Statement by

G. William Miller

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking, Finance and Urban Affairs

House of Representatives

July 28, 1978

Mr. Chairman, members of this distinguished Committee, it is a pleasure to meet with you today to present the report of the Federal Reserve on the outlook for the economy and monetary policy.

. . ECONOMIC GAINS CONTINUED AT A GOOD PACE INTO FOURTH YEAR OF EXPANSION

The current economic expansion, which began in early 1975, is now into its fourth year. Only one postwar upswing--that beginning in 1961--has lasted significantly longer. Thus, we have had an unusually durable expansion, and it has been well sustained thus far this year, as may be seen in attached Chart 1.

Especially encouraging has been the performance of the labor market. Payrolls have swelled by more than 2 million workers since last December. The over-all unemployment rate has dropped below 6 per cent, and the rate for heads of households is 3.6 per cent. Joblessness among youths and minorities remains disturbingly high, but these groups, too, have experienced appreciably improved employment opportunities in recent months.

. . AND ECONOMIC INDICATORS POINT TO FURTHER GROWTH

The willingness of businessmen across the country to hire in such large numbers suggests that they are looking forward to further growth of production. And, indeed, economic indicators generally point in that direction. As may be seen in Chart 2, buying sentiment still is at a high level, and with recent employment gains providing an impetus to income, consumer spending should continue to rise.

In the business sector, cautious inventory management has kept stocks in good balance in most sectors; rising sales are therefore likely to prompt further advances in inventory investment. Various

surveys of business intentions--as well as data on equipment orders and construction contracts, shown in Chart 3--suggest moderate increases in capital spending in the months ahead. In addition, our net export balance, which has deteriorated over the past two years, has begun to improve. Imports are likely to rise less rapidly during the next year. At the same time, exports should pick up if activity abroad increases as expected and as the changes in exchange rates that have occurred since last fall improve the competitive position of U.S. goods.

The increase in housing starts last month suggests that construction activity will remain at a high level over the near-term, but it appears likely that building will begin to taper off later this year, partly as a consequence of the firmer conditions prevailing in the mortgage market. And growth in State and local government expenditures probably will remain modest, in light of the increasing pressure for restraint in public spending.

On balance, the various indicators of spending and activity suggest that the current expansion will continue in the year ahead. As an expansion matures, however, growth can be expected to moderate, and I think it is likely that over the next four quarters real GNP will grow by about $3\frac{1}{2}$ to $3\frac{3}{4}$ per cent. Such a pace should be adequate to keep unemployment from rising; during the second quarter of 1979, the unemployment rate may average $5\frac{1}{2}$ to 6 per cent.

. . INFLATION, HOWEVER, IS A SERIOUS CONCERN

As an expansion continues there is also always the danger that developing imbalances will weaken and ultimately dissipate its forward thrust. The greatest threat to the present expansion lies in accelerating inflation. As indicated in Chart 4, price increases have stepped up sharply so far this year--through May, consumer prices rose at an annual rate in excess of 10 per cent. To be sure, much of this surge is attributable to adverse developments in the volatile agricultural sector, and relief from double-digit food price increases should be forthcoming later this year. But the prices of other goods and services also have been rising briskly recently, and the advance in unit labor costs--a key determinant of price trends--has accelerated. My best guess is that during the four quarters ahead prices in general will rise at an average rate of 7 to 7½ per cent.

With the economy moving into a period of heavy collective bargaining, the intensified inflation we have been experiencing and the greater tautness of labor markets could be reflected in higher wage demands, and if they are met, labor costs would rise even more rapidly. As it is, these costs will be boosted early next year by additional mandated hikes in social security taxes and in the minimum wage. The continued interplay of wage and price rises, coupled with the legislated cost increases, will make it difficult to achieve much relief from underlying inflationary pressures over the next year.

-4-

The strong momentum of inflation must be a central consideration for government policy-makers today. If we pursue a course that does not soon contain the forces accelerating the advance of prices, the result will be increasing economic disruption and distortion, ending in all probability in serious recession. Monetary policy has been--and will continue to be--designed to restrain inflation. But monetary policy cannot do the job alone. Placing too great a burden on monetary policy would entail dangers of severe financial dislocation that could have unfortunate longer-run consequences for the domestic and international economies.

. . FINANCIAL MARKETS SHOWING INFLATIONARY PRESSURES

Financial markets have already begun to show the strains of inflationary pressures. Debt burdens have grown tremendously as households and also businesses have borrowed to finance desired real outlays at rapidly rising prices. Financial institutions meanwhile have experienced declining liquidity as they have attempted to accommodate heavy loan demands. The most obvious sign of these mounting pressures of supply and demand in credit markets has been the upward path of interest rates since the spring of 1977, shown in Chart 5. The increase of interest rates can be attributed in good part to the diminishing confidence of borrowers and lenders that inflation will slow in the future.

The willingness of households to go heavily into debt at relatively high interest rates in some degree reflects a feeling that it is best to buy now before prices rise still further. This sentiment undoubtedly has been a major factor in the demand for

houses throughout the past few years, and it seems to have played an important role in the burst of sales of cars and other consumer durables during the first half of 1978. As may be seen in Chart 6, the volume of consumer and mortgage credit extended in connection with these purchases has been growing rapidly and so has the ratio of debt repayment obligations to disposable personal income; both have reached unprecedented heights. To date, loan delinquency experience has not deteriorated significantly, so households evidently have not encountered serious problems in meeting scheduled payments; however, this situation bears careful watching.

So, too, does the apparently declining level of corporate liquidity. During the past two years profits and other internal funds of businesses have fallen increasingly short of the sums needed for investment in inventories and fixed capital. The result has been a rising volume of borrowing and a declining volume of liquid asset accumulation; balance sheet ratios have been deteriorating since late 1976, as indicated in Chart 7.

On top of these private credit demands have come sizable public demands. State and local governments have issued bonds in record volume during the past couple of years, but these governmental units also have provided funds to credit markets through a record accumulation of financial assets. The same cannot be said for the Federal government. In financing the Federal budget deficit, the Treasury has competed actively with the private sector for credit and has added to the general upward pressure on interest rates.

. . LIQUIDITY OF DEPOSITORY INSTITUTIONS HAS DECLINED

During the early stages of economic recovery, commercial banks and thrift institutions were able readily to satisfy the loan demands of households and businesses while at the same time adding large amounts of Government securities to their portfolios. In the past year, by contrast, there has been a fairly steady decline in liquidity ratios of these institutions. With rising yields on Treasury bills and other market instruments diverting funds from savings and small-denomination time deposits, commercial banks, besides curtailing security acquisitions, have issued a substantial volume of large CDs and other short-term liabilities. Meanwhile, savings and loan associations--the leading home mortgage lenders--have reduced their holdings of Treasury securities and have borrowed heavily from Federal Home Loan Banks and other sources.

. . GROWTH IN M-1 HIGH RELATIVE TO LONG-RUN RANGES, BUT M-2 AND M-3 WITHIN THEM

The Federal Reserve might have attempted to alleviate some of the liquidity pressures in the economy by aggressively providing bank reserves and money. But at best this would have offered no more than a temporary palliative. And it would have set the stage for an explosion of monetary expansion and exacerbated our problem of inflation.

As it is, since early 1977 there has been a rather persistent tendency for growth in the narrow money stock, M-1, to run above the rates the System had projected. Over the past four quarters, for example, M-1--which includes only currency and demand deposits--

increased 7.9 per cent. As shown in Chart 8, this was well above the 4 to 6½ per cent range reported to this Committee a year ago.

Over the same four quarter span, however, the broader monetary aggregates--M-2 and M-3--recorded net increases that were well within their announced ranges. Chart 9 depicts the behavior of M-2, which is M-1 plus time and savings deposits at commercial banks (other than large negotiable CDs). M-3 includes also time and savings deposits at thrift institutions.

The fact that growth rates of M-2 and M-3 remained within their ranges over the past year, while M-1 growth was strong, is attributable to the slowing in expansion of the interest-bearing components of the broader aggregates. A year ago, yields on shorter-term market debt instruments were below those that depository institutions are permitted to pay on savings and small-denomination time deposits. But as market rates rose, they surpassed the regulatory ceilings, prompting many savers to divert funds from deposits to Treasury securities, money market mutual funds, and other higher yielding investments.

. . NEW CERTIFICATES ENHANCE GROWTH OF TIME AND SAVINGS DEPOSITS

To help preserve the competitiveness of depository institutions--and thus to avoid the distortion of credit flows that might occur if these intermediaries were unable to accommodate borrowers who do not have access to open market sources of funds--the Federal regulatory agencies created two new deposit categories, effective

June 1. One is an 8-year time deposit on which banks may pay up to 7½ per cent and thrift institutions up to 8 per cent. The other is a 6-month, \$10,000 minimum balance account whose ceiling is determined by the results of the most recent weekly auction of 6-month Treasury bills. Banks are permitted to pay a rate equal to the average discount yield in the auction, and thrift institutions a quarter percentage point more.

A noticeable pick-up in inflows to savings and small time deposits in June is evidence of the success of depository institutions in exploiting the new certificates. The 6-month floating-ceiling certificate appears to have been quite effective in stemming the outflow of funds into market investments. An estimated \$8½ billion of the new instruments were issued in June alone--\$6½ billion at thrift institutions--and growth has continued brisk this month.

. . NEED TO RESTRAIN INFLATION

The Federal Open Market Committee at its meeting last week considered carefully these recent patterns of monetary expansion, as well as the prospects for the economy, in deciding on the appropriate longer-term ranges for the monetary aggregates. Although, as always, members of the Committee differed somewhat in their appraisal of the outlook, there was a broad consensus that inflationary pressures would remain strong, if not strengthen, in the year ahead. While the recently published 5.7 per cent unemployment rate is not low by historical standards, most analysts agree that the unemployment levels at which inflationary pressures are likely to mount have been raised substantially by compositional changes in the labor force and

by the effects of unemployment compensation and other institutional factors on decisions regarding work. Under the circumstances, it is critical that macro-economic policy be conducted most prudently at this juncture to assure that economic expansion continues at an appropriate pace without fueling the already unacceptable intensity of inflationary pressure.

. . MONETARY GROWTH RANGES UNCHANGED

Growth ranges for the monetary aggregates selected by the FOMC for the year ending with the second quarter of 1979 are identical to those announced three months ago. The range for M-1 is 4 to 6½ per cent; for M-2, it is 6½ to 9 per cent; and for M-3, 7½ to 10 per cent. The growth range for bank credit, though, was raised to 8½ to 11½ per cent in recognition of the greater share of borrower demands being directed toward banks.

The Committee discussed at some length arguments in favor of raising the upper limit of the range for M-1. A major part of the discussion focused on the question of whether the persistent tendency over recent quarters for M-1 growth on average to overshoot the FOMC's longer-run range represented a fundamental shift in the demand for M-1 relative to GNP that should be accommodated. The Committee concluded that an upward adjustment in the range at this time would be undesirable in light of continuing inflationary pressures. Nonetheless, it was recognized that, in light of the recent behavior of money demand, growth in this aggregate over the year ahead might well be around its upper limit.

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Scheduled regulatory changes could lead to a lower measured growth in M-1, however. Once the new regulation allowing automatic transfers of funds from savings to checking accounts goes into effect this coming November, the public can be expected to economize more on demand balances and to shift some funds from demand deposits to savings deposits. Such shifts would tend to reduce growth in M-1 during a transition period in which bank customers adjust to the new service. But the extent to which such a shift in funds will occur over the year ahead is quite uncertain. It will depend on the structure of service charges posted by banks for the new service and on the speed with which the public takes advantage of the added flexibility in cash management. In the transition period, therefore, M-1 will become a less reliable indicator of monetary conditions.

The broader monetary aggregates are not likely to be affected significantly by the automatic transfer regulation. They are expected to grow well within their current ranges in the months ahead, with growth sustained in part by the availability of the new certificate accounts. Thus, a generally ample flow of credit through banks and thrift institutions can be expected.

There are always great uncertainties surrounding monetary projections, but the FOMC believes that these ranges for the four quarters ahead are consistent with further moderate expansion of economic activity. Unfortunately, I cannot report that the Committee expects a diminution of inflationary pressure over the coming year. A reduction in the rate of price advance will require

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more time if it is to be accomplished in an orderly manner, given the present built-in biases toward inflation in the country.

These biases--regulatory, legislated, and expectational--prevented the Committee from taking a further step at this time toward the lowering of the monetary growth ranges--a process that must be continued over time if the nation is to achieve reasonable price stability. In any event, under current circumstances, continuation of the present growth ranges for the aggregates implies a continued posture of restraint against inflationary pressures and probably involves some additional--but tolerable--liquidity pressure on financial intermediaries.

. . NEED FOR A LONGER RANGE EFFORT TO TREAT STRUCTURAL PROBLEMS

These observations underscore the limitations of monetary policy as the main bulwark against inflation, and the need to mount a broad attack on the economic problems we face. A significant reduction in the Federal budget deficit would be an important first step in reducing inflationary pressures. But a longer range effort to treat the structural problem of inflation also is necessary.

We must re-shape our tax laws to make certain that there are adequate incentives for saving and investment. The nation has for many years now devoted too large a proportion of its production to consumption and too small a share to the expansion and modernization of its industrial plant. As a result, productivity growth has languished, with serious consequences for inflationary trends and our standard of living.

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We must take steps as well to bolster our position in international trade and thereby to strengthen the dollar. We should continue to seek freer access to world markets and attempt to make American businessmen more aware of opportunities for sales abroad.

We must seek ways of training and placing those individuals who, because of lack of skills or limited knowledge of employment opportunities, are not readily absorbed into the work force.

And we must remove the impediments to competition, relieve the undue regulatory burdens, and avoid the costly governmental actions that have contributed importantly to inflationary pressures in recent years.

It is important to take strong measures now to curb inflation, and with the continued cooperation of the Administration, the Congress, the Federal Reserve, and the private sectors of the economy, I believe that we can within the next several years establish an economic environment conducive to full employment with price stability.

Chart 1

OUTPUT, EMPLOYMENT, AND UNEMPLOYMENT

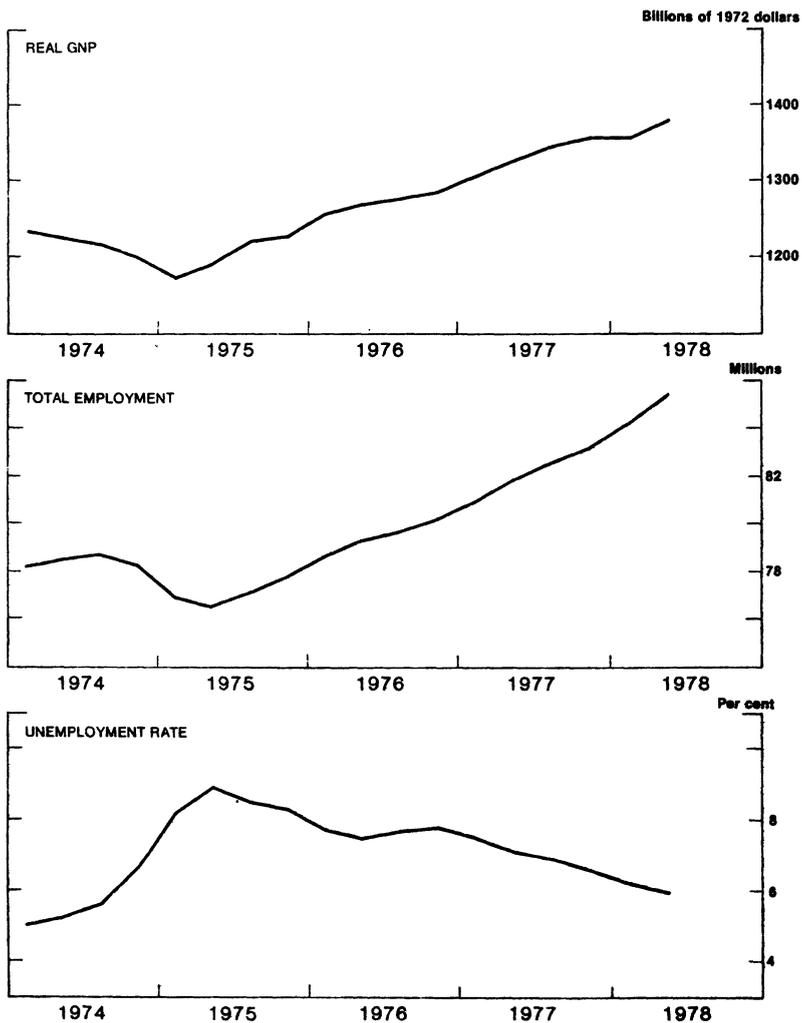
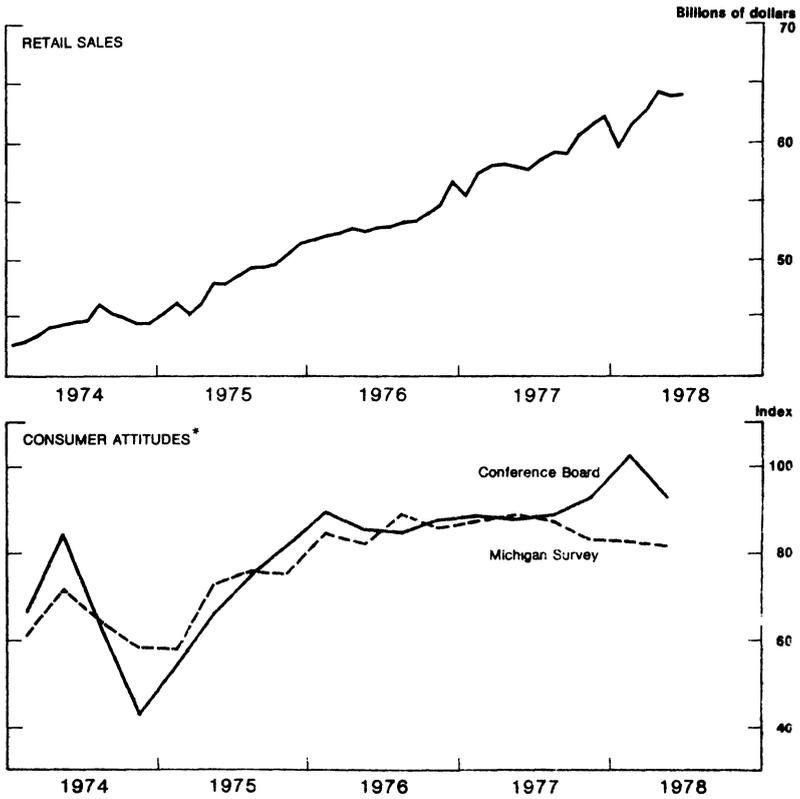


Chart 2
CONSUMER SECTOR ACTIVITY



* Conference Board index of consumer confidence, 1969-70=100.
 Michigan survey index of consumer sentiment, 1966 Q1=100.

Chart 3

BUSINESS CAPITAL SPENDING ACTIVITY

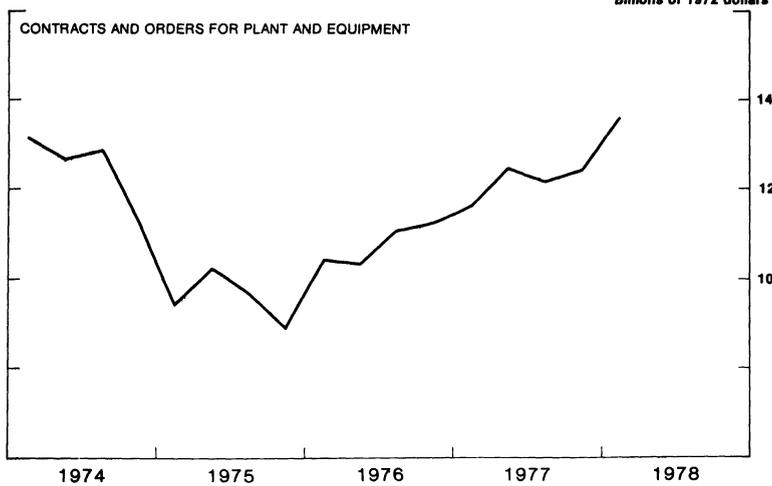
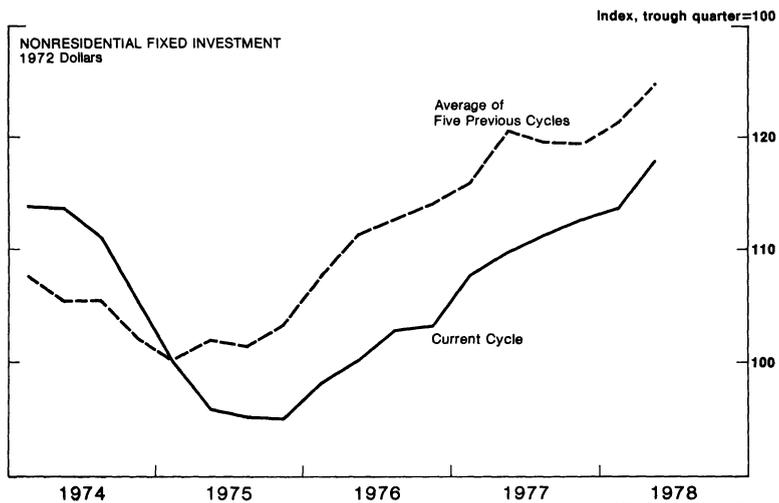


Chart 4

MEASURES OF AGGREGATE INFLATION

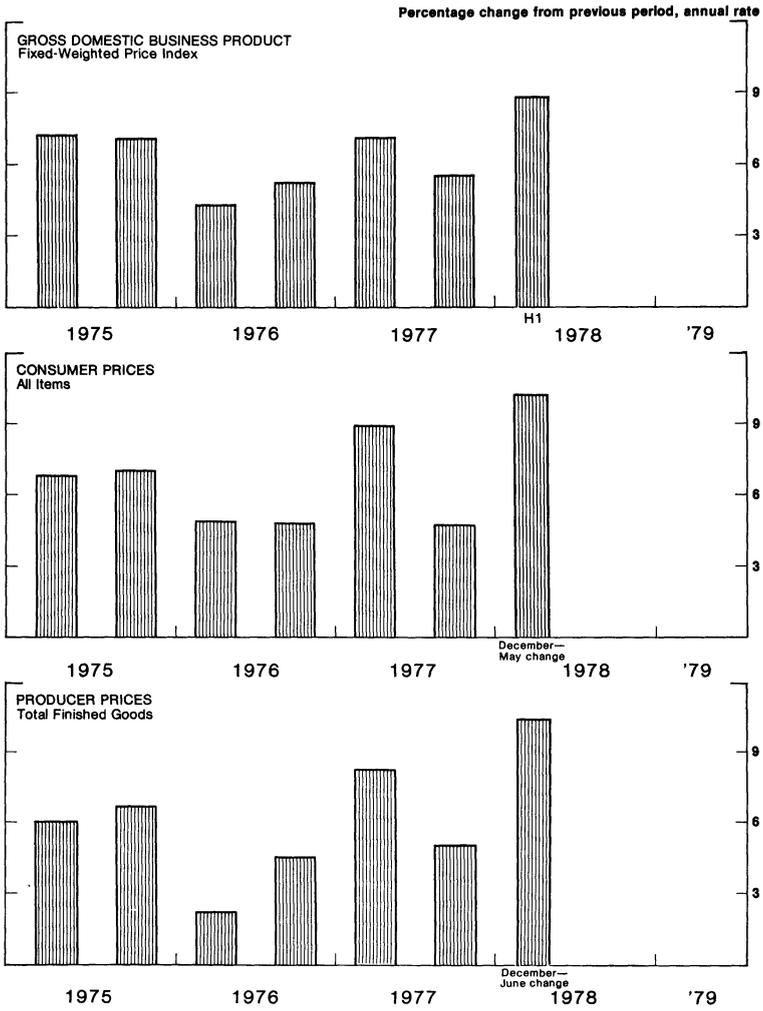
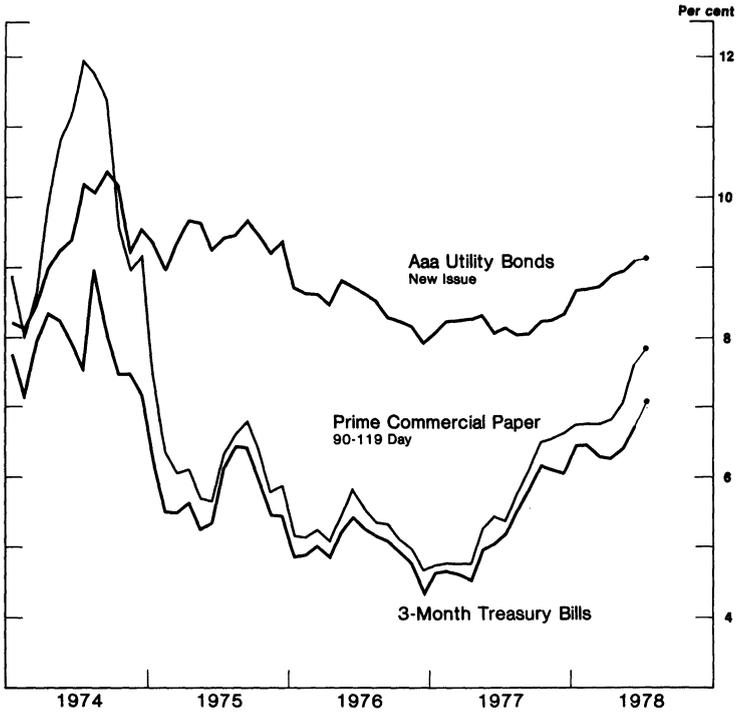


Chart 5
INTEREST RATES



• Week of July 19th

Chart 6

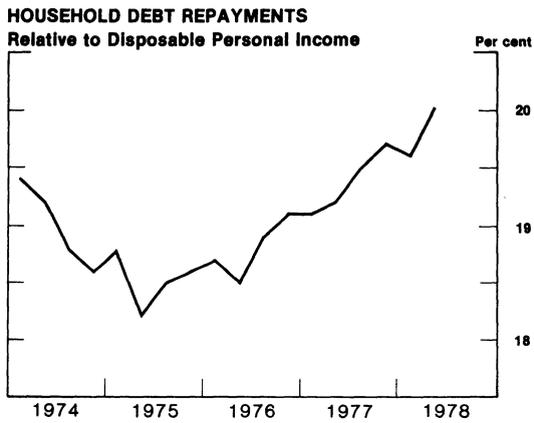
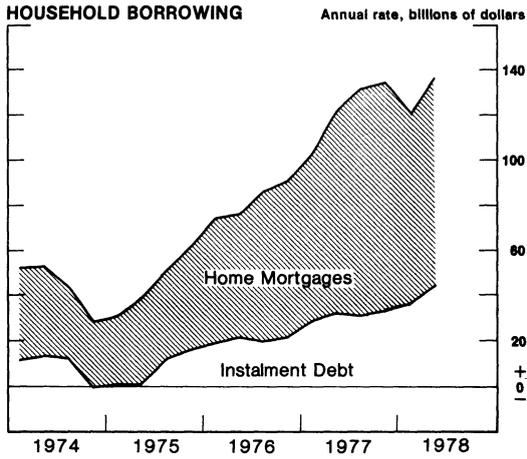


Chart 7

CORPORATE FINANCE

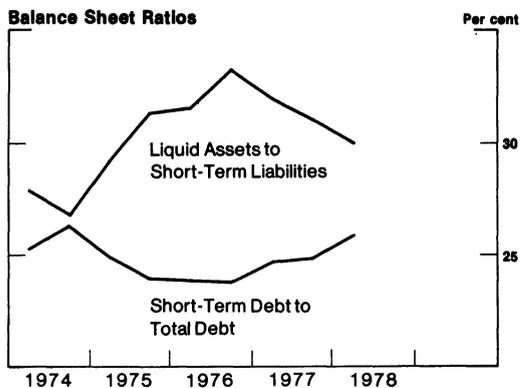
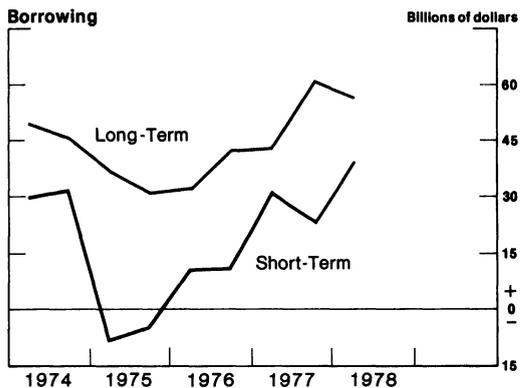


Chart 8

RECENTLY ESTABLISHED M-1 GROWTH RANGES AND ACTUAL M-1

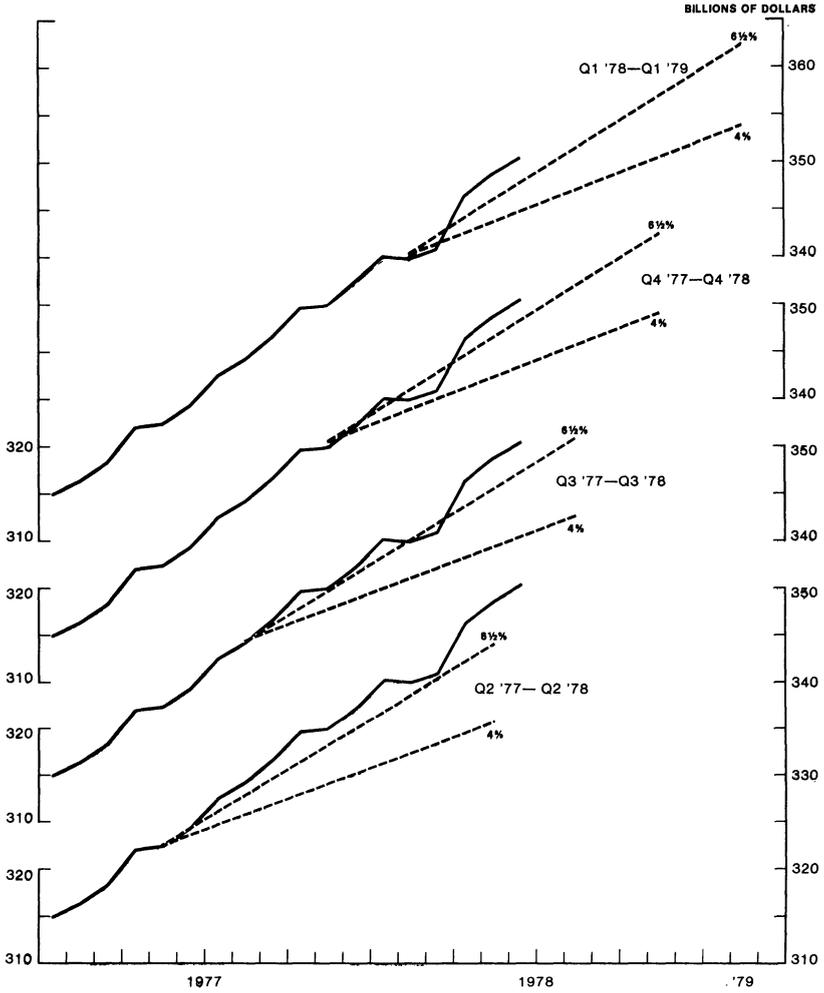
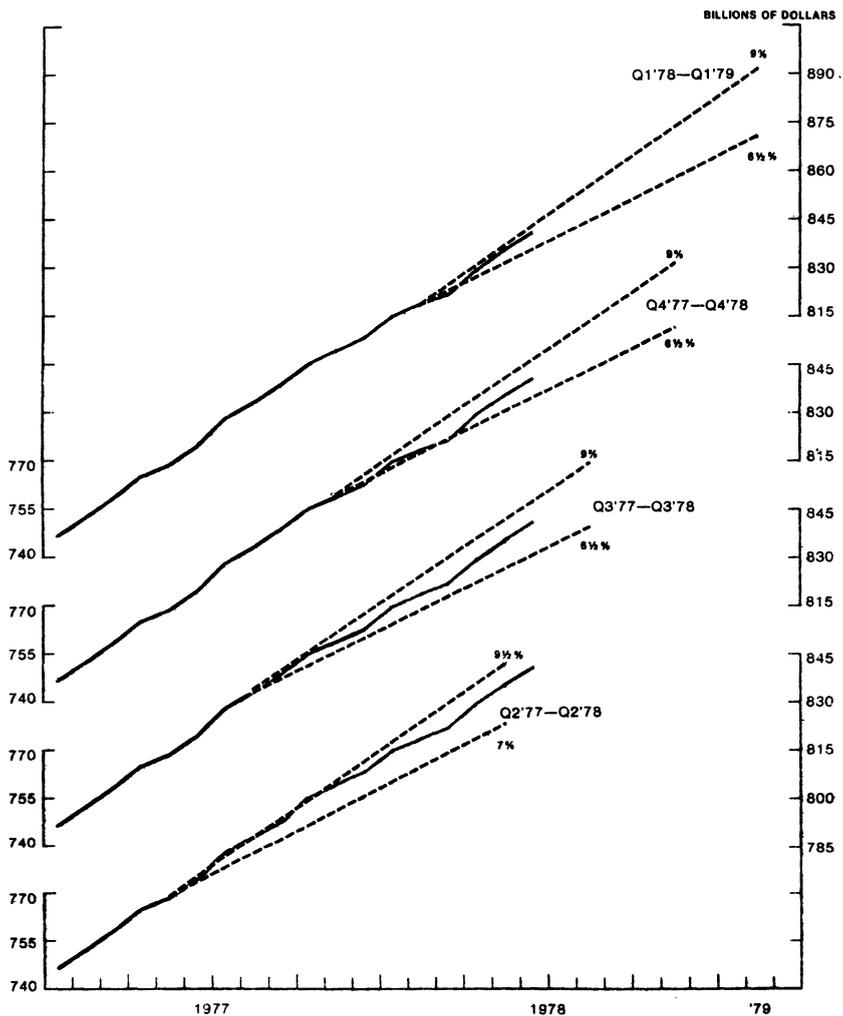


Chart 9

RECENTLY ESTABLISHED M-2 GROWTH RANGES AND ACTUAL M-2



The CHAIRMAN. Thank you, Chairman Miller.

As you know, your writ runs to monetary policy. I have applauded your looking at our economy in whole, and giving very detailed specifics from time to time on such matters as taxes, which are not jurisdictionally yours, or international trade, which is not jurisdictionally yours, or regulatory matters which are not jurisdictionally yours, and so on.

There is one field, however, in which I believe there is a peculiar problem and in which you, by happy good fortune, have a peculiarly good background, on which you have not been as specific as I would like to see you.

On page 12, the last page of your written report today, when you tick off some of the things that I think most members of this committee would agree with you ought to be done, you say:

We must seek ways of training and placing those individuals who because of lack of skills or limited knowledge of employment opportunities are not readily absorbed into the work force.

Well, we all know the brute statistics. Overall unemployment is, encouragingly, going down from above 8 percent to presently 5.7 percent. But, minority unemployment in our central city ghettos and pockets of rural poverty still pushes 40 percent and is a social as well as an economic shame.

I know that you and your staff have explored the relative efficacy of incentives to build plants and paying an employer part of the minimum wage, a tiny bit of which, incidentally, has been adopted by the administration.

But really, would it hurt the fight on inflation if we now mounted a vigorous rifleshot, carefully calibrated approach on what is called structural unemployment?

Could I ask you perhaps to supplement your one sentence in the record this morning—we don't expect you to discuss everything at great length—with quite a specific program for dealing with structural unemployment now, without raising inflation?

I think it can be done. I think you agree.

Mr. MILLER. Mr. Chairman, I do agree.

The CHAIRMAN. Don't hide your light under a bushel. Let us have it.

Mr. MILLER. I do agree with you. Obviously, as you have pointed out in the past, if we try to address the problem with macroeconomic policies then we do increase inflationary pressure and destroy the prospects for a long-term solution to the problem.

But I do agree with you that there is nothing inconsistent with our policy of restraining inflation to have a parallel, intensive effort targeted to structural unemployment. I concur that it deserves high emphasis and high priority.

It is a socially unacceptable condition to have the high rates of unemployment we have for teenagers—particularly for minorities, and particularly in central cities.

I would be happy to submit, if you like, a series of suggestions for reducing structural unemployment. Although that is not my jurisdiction, I do feel strongly that this needs to be done for the long-term good of our economic and social structure.

I would be happy to supply you with some specific ideas, if you would like.

[Chairman Miller subsequently submitted the following information:]

PROGRAMS TO REDUCE STRUCTURAL UNEMPLOYMENT

Policies to reduce structural unemployment should be designed to improve the quality of the work force, facilitate the flow of information about skills needed in a growing economy, and provide for effective job placement. In my view, the following principle should be embodied in programs intended to ameliorate structural unemployment:

Emphasis should be placed on preparation for and direct placement in growing industries. Over the years the private sector has generally provided the bulk of the net increase in payroll employment; reflecting this, structural labor market policies should be aimed at identifying and meeting the needs of private sector employers. Moreover, as the House Labor Committee Report on H.R. 12452 (CETA reauthorization) points out, the majority of job openings in the private sector are found in small businesses [those with fewer than 500 employees]. Thus, structural labor market policies should have a decidedly local emphasis.

The design and operation of training programs should include local employers, educators, and public officials. Training and guidance programs are likely to be most successful when employers have a direct role in specifying their needs. Indeed, participation by business in such programs often leads to an increased willingness to hire graduates or provide on-the-job training. Similarly, the willingness of educators to adapt curricula to provide students an exposure to the world of work, and the commitment by community leaders to direct their employment and training funds to meet the needs of the local economy are most likely to be forthcoming when they are direct participants.

More generally, incentives to create jobs for the structurally unemployed should be provided and disincentives should be eliminated wherever possible.

SPECIFIC ACTIONS TO ADDRESS STRUCTURAL UNEMPLOYMENT

The administration has recognized the importance of coordinating training programs with private sector needs in its proposal for private sector opportunities for the economically disadvantaged, which has been included as Title VII in legislation reauthorizing the Comprehensive Employment and Training Act (H.R. 12452 and S. 2570). I strongly support this program, which is designed to demonstrate the effectiveness of directly involving the local business community—particularly small businesses—in the planning and operation of training programs. Local private industry councils will be created by each CETA prime sponsor, and, in cooperation with the sponsors, these councils will have the opportunity to direct the use of funds for private sector initiatives. The activities allowed by the legislation are sufficiently broad to encourage innovation. Employers, educators, and manpower planners should be able to develop new linkages that will help meet the demands of private businesses for specific work skills by providing coordinated training and direct placement of the structurally unemployed in permanent private sector jobs. The needs of the unemployed and their future employers should be better served by such a cooperative arrangement than by the traditional approach of large training efforts, which may not have been based on the fullest possible knowledge of the needs of local employers. The main thrust of this program is efficiency through local decisionmaking, but a national leadership role—on the part of the Labor Department and the National Alliance of Businessmen—is provided to assure technical assistance and to facilitate the sharing of ideas.

Programs to facilitate the movement of youths from school into good jobs. The transition from school to work is a critical period in a youngster's life. Yet it is a transition which has not had sufficient attention in national policymaking. The nonprofit National Manpower Institute has been promoting the establishment of community education-work councils. There are currently over 30 of these operating, funded either by the Labor Department or nonprofit sponsors. These councils are comprised of government, education, business, and labor representatives. Their purpose is to collaborate with educators on relevant curricula, to develop work-study opportunities, and to help improve placement assistance and career guidance activities for students. This is an important effort that should be expanded.

In addition to education-work councils, other ways must be developed to strengthen the linkages between private sector businesses and secondary schools. Such programs can afford youngsters the opportunity to learn first-hand about the world of work before they make career decisions. One plan that has been successful involves the "adoption" by business of a school. In this arrangement, young people are given an opportunity to experience what adults actually do on the job. These

programs should include hands-on activities where possible, and as much in-plant and in-office involvement as can be managed. It is important that these programs have the full support and cooperation of business leaders, parents, and educators, and that the work-place experience be integrated into formal classroom activities.

The Youth Employment and Demonstration Projects Act signed in August 1977 has funded a series of demonstration projects designed to indicate the feasibility of cooperative efforts by employers, schools, and community organizations to provide special career development assistance to youths. Other experimental efforts under the Youth-Act umbrella are testing the value of guaranteed work opportunities for youths in order to encourage them to stay in school or to return and finish their classroom education. These demonstration projects should be evaluated carefully, keeping in mind the goals of developing mechanisms for continued cooperation among schools, employers, and community leaders, and the emphasis on serving the needs of the private sector.

Eliminating barriers to employment. Many studies indicate that the minimum wage significantly limits employment opportunities for entry level workers, mainly teenagers. Nevertheless, the House of Representatives defeated last year (by only one vote) an amendment allowing employers to pay teenagers 85 percent of the Federal minimum wage during the first six months of employment. Some such legislation should be reconsidered in light of the 1½ million teenagers who have been looking for jobs in recent months. If unwilling to provide a special minimum wage for young workers, the Congress should give consideration to the administration's proposed tax credit of \$2,000 in the first year and \$1,500 in the second year for employers who hire disadvantaged youth, even though a differential minimum wage for youth might have a broader impact, and would be less costly to taxpayers.

Incentives to create jobs in high unemployment areas. Recently, Congressional leaders have shown increasing awareness that accelerated depreciation allowances and an increase in the investment tax credit would spur business investment. In an effort to revitalize our Nation's cities and to create jobs in high unemployment areas, Congress also should investigate the possible merit of supplementing any general policies to stimulate investment with differential incentives for business expansion and renovation in high-unemployment areas. As a part of its urban program, the administration has proposed an additional 5 percent investment tax credit for firms that locate or expand in depressed areas. An alternative that could be considered is a speed-up in allowable depreciation for firms in those areas to discourage them from moving or closing. Congress should study these tax incentives as possible methods of promoting the growth of job opportunities in the private sector, particularly in areas with the greatest concentrations of the structurally unemployed.

The CHAIRMAN. Thank you.

It would be particularly valuable because here in the Congress we are strung out all over the lot on committee jurisdiction. There are half a dozen committees that have a piece of this action.

Our record of getting together with something that is both effective and noninflationary isn't very good. I know you can help us.

Mr. MILLER. There is one legislative item that I have pointed out recently—namely, the increase in the minimum wage scheduled for January 1—that works very heavily in increasing inflation and makes it more difficult to get teenagers into starting job positions so they can work their way up to higher incomes. I don't mean to dwell on this because I think the attack on structural unemployment must be a broad one. But I would certainly like to see a differential for youth so we can at least get them started in jobs.

The CHAIRMAN. Try your hand at that, because I think it is important. Remember, of course, that—and here I am being so honest it isn't even funny—this whole thing bogged down on a Republicans versus Democrats vote, with the Republicans saying do away with the minimum wage for first entrants, and the Democrats saying don't, you will fire old Emil, who has been with the company for 45 years.

Nobody knows the answer. It would seem to me in a pluralistic economy like ours, you could find 10 or 15 different labor markets and try a differential for a couple of years and see what happens.

It is noteworthy that Socialist England and Socialist Sweden try a differential, and it seems to work.

Mr. MILLER. The differential lost by only one vote in the House. I don't know the political background, but I do know that the vote was taken before we knew the clear and present danger of inflation. So if one vote would be switched—because inflation has become such a problem and because that minimum wage increase on January 1 will add one-half percent to the rate of inflation next year—there are not many actions that could so simply reduce the rate of inflation by one-half percent. And I believe that would contribute to job opportunities rather than hurt employment.

The CHAIRMAN. If you wanted the one vote to be my vote, you would have to work out some system whereby you tried it in a number of labor market areas, to try to establish practically on the ground where the truth lay.

Anyway, I have great confidence in your ingenuity.

Mr. MITCHELL. Will the distinguished chairman yield?

I know it is very unusual to ask the chairman to yield.

The CHAIRMAN. I do.

Mr. MITCHELL. I take this unusual step merely to point out I am not happy about what you intend to do. Obviously, there are some very serious implications in what you say about a differential for youth unemployment.

The harsh fact is, as I read your report, that you intend to have real GNP grow at a relatively low rate. That simply means that there will be no marked decrease in unemployment.

If however, you come in with the youth differential, there may be a marked decrease, but you are merely trading off young people in terms of a retarded real GNP growth.

I just wanted to make that comment, and I want to get back to it later on, if I have time.

The CHAIRMAN. We don't want to prolong this in view of the time, but that is the question and that is why I would like to see whether maybe the Fed isn't smarter than we are. It is theoretically possible. [Laughter.]

We will give you a try.

One final question on another subject. This perennial series of correspondence between the committee on the one hand and the Fed on the other, in which I think since about 1965 we have been saying why do you maintain lagged reserve requirements with required reserves dependent on deposits 2 weeks earlier?

Is it not true, that this lag, which you impose for reasons that don't seem to me a sufficient mandate, is one of the reasons why your M_1 figures have been so out of line with reality.

We haven't gotten an up-to-date answer. We have got some old staff studies. I know you have had many things to do in the last 4 months, but could we have a cradle to grave study of lagged reserve requirements, about which even Prof. Milton Friedman would say, well, at least they have made an attempt to answer me.

Mr. MILLER. Mr. Chairman, I could give you an up-to-date answer right now. I think it would be preferable to go on a current basis. I think that we should—

The CHAIRMAN. Hallelujah, that is wonderful.

Mr. MILLER. The problem with doing that is timing and the burden on banks—especially small banks. I have felt that once we can do some of the things we have proposed to alleviate the membership burden, we should be prepared to do away with 2-week lagged reserves. The only reason I have not pushed for additional study of that suggestion is because of the burden on member banks. In terms of operations, it would be preferable to be on a current basis.

The CHAIRMAN Well, that is a—

Mr. MILLER. There is not much more to add, except that we need to figure out the right time to do it. I don't speak for the Board now, I speak for myself personally—but I believe the Board would be sympathetic, once we relieve the other pressures affecting membership particularly for the small banks that do complain about the regulatory burden on them. The large banks can handle it more easily.

The CHAIRMAN Let me hastily end my questioning, because you have shown a big glimmer of hope on ending lagged reserve requirements. Since one of the main differences as of now between the Fed and many members of this committee on Federal Reserve reserve requirements reform has to do with the desire of many members of this committee to give the smaller banks a little bigger break—maybe there is an opportunity for some profitable business here.

Thank you very much.

Mr. Stanton?

Mr. STANTON. Mr. Chairman, it is always a pleasure to have you back with us.

I notice in your statement that you brought out the fact that the current expansion we are enjoying and having in this country is now into its fourth year. We hear this morning verification that we are now in the double-digit inflation era.

What are your thoughts in regard to the economy the remainder of this year, the first part of next year? Do you think expansion will continue?

Mr. MILLER. Congressman Stanton, we have had an uneven growth rate in real GNP during the first half of the year, with zero growth in the first quarter and a reported rate of 7.4 percent in the second quarter. In my opinion, the final figures may be a little higher than that for the second quarter so one can say we have had an average growth rate of around 4 percent for the first half.

In terms of predicting the outlook, one first must look at the condition that has existed. And looking at the pressures on credit, looking at the general difficulties of an economy in a mature stage, we would normally expect there to be a slower rate of growth at this stage, particularly if it is to be sustained.

If growth continued at too high a rate, then there would be excesses, there would be a build-up of production in excess of final demand, then there would be a need to cut back at some point, and there would be a recession.

Our view is that, with the combination of policies that are developing, we can expect the economy to slow somewhat from the first half to a $3\frac{1}{4}$ - $3\frac{3}{4}$ percent growth over the next four quarters.

We would all have slightly different opinions as to how it will fall quarter by quarter. It may be relatively slower in the fourth quarter this year and relatively higher in the first quarter of next year, but I think the general range of $3\frac{1}{4}$ - $3\frac{3}{4}$ about what we should expect at this time.

Mr. STANTON. Mr. Chairman, one of the first statements you made before our committee on your appearance on this same subject, about 5 months ago, was on the subject of inflation.

You were quick to point out that this indeed was our No. 1 economic problem. You were going to devote your energies toward halting the increase in inflation.

I do wish to applaud you. You have gained many converts in the last 5 months on this subject matter. You have made a very impressive witness. Many of the people here on the Hill who did not know you have become very impressed with your performance, and I congratulate you on that.

After saying that, I wonder if you could tell us, what seemed out of character was the fact that in that Open Market Committee meeting, the one preceding the one yesterday I think it was, in which the Board took a certain action, and you voted contrary to that.

I wonder if you could tell us, it didn't seem in character with what you had been doing.

Mr. MILLER. Mr. Stanton, let me first point out that it was not an FOMC meeting; FOMC meetings deal with issuing a directive for the desk on open market operations and setting the ranges for monetary aggregates.

The approval of a discount rate change, on the other hand, is made by the Board of Governors based upon the recommendation of the Federal Reserve banks. My vote was cast at a meeting of the Governors on a discount rate action.

Now, that meeting followed some tightening action we had just taken at an FOMC meeting. Since the tightening had only recently taken place at the time of those recommendations, I thought we needed a week or two more to see how that action would affect the growth of the aggregates before we raised the discount rate again.

My hesitation was as to whether we should wait and increase it more or whether we should wait and take different action. I felt the data available was a bit inadequate and that we should wait, but I felt there was no reason for me not to vote on that basis.

I see nothing inconsistent with that and continuing actions of the FOMC and the Board of Governors to restrain inflationary forces and operate a prudent monetary policy.

But on any particular day, in looking at market conditions, we will have differences of opinion within a quarter percent as to just what the rate should be at the moment. So it was a question of timing.

As I said in hearings yesterday, it turned out that the aggregates were still pretty strong, so, I think the action was appropriate. It might have gone the other way and I might have been right, but it

turned out that those who voted for the increase had a pretty good crystal ball.

Mr. STANTON. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Moorhead?

Mr. MOORHEAD. Thank you, Mr. Chairman.

Welcome, Chairman Miller. Since the chairman has gotten outside of the narrow scope of monetary problems, I will do so, too.

On page 11 of your testimony you say, "We must reshape our tax laws to make certain that there are adequate incentives for saving and investment."

Are you thinking about the reduction in the capital gains tax, or a much broader program than that?

Mr. MILLER. Congressman Moorhead, greater incentive for business fixed investment is one of the critical needs if we are to sustain economic growth and particularly if we are to reduce the cost of production and make productivity gains. That would break the cycle of wages chasing prices and prices chasing wages, which is the most critical issue we face.

We can do all kinds of things that have been talked about in general terms. But that cycle will continue unless we find some way to start bringing costs down. In my view, that requires a major program, over a long period of time, of increased investment that yields the modernization and increased productivity we need.

If I were the sole person making decisions in Washington, I would concentrate very heavily on tax decisions that accomplish that result. Along with relief for individuals from the progressivity of the income tax—with inflation working personal income into higher brackets—I think this is of very high priority.

Next we must ask how to accomplish that, and I would take targeted action.

I do not believe that changes in the capital gains rate have a direct impact. They have a very long lag and an indirect impact on actual decisions made within corporations to invest money in plant and equipment. They have an effect on the taxes—the profit—of individuals who buy stocks, but may not necessarily generate any more investment in the corporation itself or in capital expenditures made by the corporation. A corporation's decisions don't change because its stockholders are being taxed more or less on trading of securities. But a corporation will spend more for investment if its own risk on investments is reduced.

That would be best accomplished—most efficiently accomplished—by a substantial increase in depreciation allowances. Corporations measure their potential markets, their sales, their costs, and their profits against the cost of the investment, using a discounted cash flow analysis.

The faster the writeoff, the higher the discounted cash flow and the less risk for a new investment. That is why accelerated depreciation is the most direct, efficient way to stimulate investment—there is more bang for the buck, less cost to the Treasury and more impact on investment.

If only so much money can be taken away from the Treasury through tax policy at this time, I would take it for that purpose, and I would put off until next year the question of capital gains rate reductions.

Mr. MOORHEAD. You would have your depreciation still based on the cost of the equipment, not based on its replacement cost?

Mr. MILLER. I am opposed to depreciation based on replacement value because that would result in tax deductions for existing plant and equipment. It would reduce the taxes for businesses, but it would not necessarily generate any new investment.

In the case of accelerated depreciation on new investment, the benefit flows only if a new investment is made. There is a direct linkage, just as clear as it can be. But if one permitted corporations to take more depreciation allowances on already existing plant and equipment, that wouldn't change a single decision; they would just owe less taxes.

Mr. MOORHEAD. Mr. Chairman, going back to monetary policy, on page 4 you say, "Monetary policy has been and will continue to be designed to restrain inflation." On page 6 you say, "Since early 1977 there has been a rather persistent tendency for growth in the narrow money stock M_1 to run above the rates the system had projected."

These statements to me seem contradictory. Can you reconcile them?

Mr. MILLER. Yes, I believe so. In the first place, M_1 , as an isolated measure of potential purchasing power and the availability of credit in the economy, is an inadequate measure. M_1 has to be viewed along with other measures which include funds in savings and time deposits that are readily convertible into cash.

M_1 has been behaving with more strength in this particular phase of the economy, for a number of reasons which perhaps we need to understand better. M_2 and M_3 have been within the ranges set by the Federal Reserve, so that generally—at least in recent times—we have had a policy consistent with trying to restrain the inflationary pressures, but at the same time trying to avoid overshooting or tightening up so much that we trigger a recession. So we are seeing M_1 behaving a little badly, but cracking down on it harder might be excessive.

We are trying to dampen down inflationary pressure, and I think it is slowly beginning to bend. We prefer, I think, to bend inflation down rather than clobber it down because that might have adverse effects on the economy.

Mr. MOORHEAD. For the record, could you submit a study showing why you consider M_2 and M_3 more reliable than M_1 ?

Mr. MILLER. M_2 and M_3 are broader and therefore less volatile. Yes, sir, I would be very glad to do that.

Mr. MOORHEAD. I say for the record because my time has expired.

Mr. MILLER. Not only that, we might spend the rest of the morning trying to explain it and I am sure there are other questions.

Thank you.

Mr. MOORHEAD. Thank you.

[Chairman Miller subsequently submitted the following for inclusion in the record of the hearing:]

It is not so much that M_1 is less reliable over time than M_2 and M_3 , but that no single aggregate can be relied on alone. For example, M_1 can be affected by shifts—often unpredictable in dimension and duration—from demand deposits to time and savings deposits at banks and thrift institutions that may occur as a result of

innovations in the payments mechanism enabling the public to hold more of their transactions balances in interest-bearing accounts. Such shifts took place in 1975 and 1976 in response to a number of developments, including the more widespread use of telephone transfers out of savings accounts, increased use of third party payment accounts at banks and thrift institutions, and authorization for businesses and state and local governments to hold savings deposits. The impact on M_1 of these innovations seems to have diminished more recently, although the regulation that is effective November 1 permitting automatic transfers from savings accounts to demand deposits may again cause substantial shifts out of demand accounts to interest-bearing deposits. Shifts between demand and time and savings deposits would not affect M_2 or M_3 , of course—which includes both non-interest and interest-bearing deposits.

When technological changes in the payments mechanism are altering the relationship between demand and interest-bearing deposits, M_2 or M_3 would be a more reliable monetary indicator than M_1 . However, these broader aggregates may in their turn be affected by shifts in public preferences for time and savings deposits relative to market instruments. Shifts of that sort would tend to destabilize M_2 and M_3 , but would have no effect on M_1 . Under those circumstances, M_1 may be the more reliable monetary indicator. On balance, though, there is little choice in practice other than to assess carefully the behavior of all three monetary aggregates—keeping in mind that the public has in recent years come to hold increasing amounts of transactions and precautionary balances in interest-bearing deposits, so that the broader aggregates tend to take on growing monetary significance.

The CHAIRMAN. Mr. Hanley?

Mr. HANLEY. Thank you, Mr. Chairman.

Mr. Miller, I was delighted with your response to Mr. Moorhead's question related to capital gains. I find myself on the identical frequency with you. I think if we were to move in that direction, ultimately we could abandon all of our public service employment programs.

I don't know whether or not you have had the opportunity yet to analyze the decisions made in the Ways and Means Committee with respect to the tax package, it having only occurred yesterday.

But in the event you have, do you feel that—as I understand it, there will be about \$4 billion there for capital gains—it went far enough, or should it have gone further, or what?

Mr. MILLER. Congressman Hanley, I do not have any philosophical quarrel with relief on taxation of capital. We need a broader based look at capital, capital formation, and rewards for capital formation.

I continue to feel, however, that timing is critical in these matters and that despite the desirability of relief from capital gains taxes—taxes on selling homes, for example—\$4 billion would do more good for more people over a longer period of time if it were devoted toward incentives to create investment and increase productivity, incentives to reduce costs and begin to break the cycle of inflation.

Inflation is a cruel tax on everyone that will be with us even though we might get relief from other taxes; we must break it. It is important first to reduce the cruel tax of inflation and to concentrate all of the resources we have on doing that.

Therefore, I do not quarrel with the decision of the Ways and Means to reduce capital gains, but I think their timing is premature. I would like to see the accelerated depreciation I mentioned substituted for that action.

Mr. HANLEY. I assume that you would, on the basis of what you have said, timing being appropriate, see us pursue a program per-

haps similar to that of the Japanese and West German Governments with respect to subsidization of industry?

Is that a fair statement?

Mr. MILLER. No, I do not think that subsidy is a healthy thing. Accelerated depreciation is not a forgiveness of taxes, it is a deferral of taxes—the recapture of the investment simply goes forward faster.

The process of subsidization—there is some in our system—is always tricky and always creates a sort of self-perpetuating interest. Subsidies are hard to unwind and to correct. Therefore, I prefer a freer operation of the economy, but with a tax policy designed to influence behavior—a kind of a behavioral economics—by encouraging private action that supports the overall economic plan.

We have invested far too little in capital in this country for far too long. We have been spending 8 or 9 percent of GNP for fixed investment. The Japanese spend over 20 percent; the Germans 15 percent. If you accumulate, over those 10 years, the gap between our relative commitments to modernization, productivity, technology, and processing, you will find we fall so far behind that it is no wonder that the Germans and the Japanese are accumulating surpluses and we are having difficulties. It is that trend that we need to reverse.

Mr. HANLEY. If I might turn to another subject on page 10, you say that in the transition period after your plan to allow automatic transfers from savings to checking accounts, “ M_1 will become less reliable as an indicator of monetary conditions.”

May I ask how long do you expect the shakedown period to last? And what will you use or recommend others use to judge the thrust of monetary policy during that transitory period?

Mr. MILLER. Mr. Hanley, during that period we will have to pay more attention to M_2 and M_3 , and we may also have to do some research and develop the possibilities of redefining M_1 to take account of this change.

I believe the transition period—until we see more or less what the pattern will be—will last 1 to 2 years. I do not think we will be without adequate tools, if we look at the broader aggregates.

M_1 is a part of M_2 . There are shifts between M_2 held in the form of demand deposits and time deposits, but both forms will be captured in M_2 . We can continue to watch this broader aggregate, even though one component of it will be a little harder to assess because we do not know how much people will decide to place funds in savings accounts with automatic transfer provisions.

Mr. HANLEY. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Mr. WYLIE of Ohio.

Mr. WYLIE. Thank you, Mr. Chairman.

Thank you, Mr. Miller, for an excellent and thought-provoking statement.

I might be repeating here a bit, but I think on balance there is an important question which needs to be carefully examined. I am having some difficulty relating a statement which you made in your report this morning, an FOMC position, and the Bureau of Labor Statistics report.

In the first part of your testimony on page 3, you say through May consumer prices rose at an annual rate in excess of 10 percent. This morning at 9 o'clock the Bureau of Labor Statistics said the Consumer Price Index was rising at an annual rate of 10.4 percent. A little later you say in your statement, "then my guess is that during the four quarters ahead, in general, inflation will rise at an average rate of 7 to 7¾ percent."

On page 10 you say: "Unfortunately, I cannot report that the Committee"—that is the Federal Open Market Committee—"expects a diminution of inflationary pressures over the coming year."

Now I find the three statements a little confusing and would like to ask the following question: If inflation is currently running at 10.4 percent and the FOMC does not expect a diminution of inflationary pressures over the coming year, does FOMC think we are going to have double-digit inflation for the coming four quarters while personally you expect considerably less inflation?

Is there a difference of opinion within the FOMC on the outlook of inflation during the next year?

Mr. MILLER. Congressman Wylie, I will have to take responsibility for the confusion and try to straighten it out. Inadvertently, we have been using different measures, and I had better put them in order.

The continued 10-percent rate of increase, which was confirmed by this morning's BLS report, is the very disturbing increase in the CPI—the cost of living—that we have been experiencing. We do expect some relief from that, particularly since a great deal of the increase in the first part of the year was related to food, first meat and then fruits and vegetables and other foods.

For seasonal reasons and for reasons of substitutes in supply, we believe that there will be some relief in the food area, so that is one reason why those particularly high rates in the CPI should not necessarily continue.

A second point I should make is that, in giving you our inflation outlook for the next four quarters, I have been using the GNP deflator. It is a different index from the CPI and I apologize for not having made that clear.

It does create confusion to be talking, on the one hand, about the Consumer Price Index and, on the other, about the GNP deflator.

The GNP deflator is projected in the 7-plus percent range over the next four quarters and we are therefore not talking about any real change in inflation from these very high, disturbing current levels. I am sorry the indexes were mixed up; I should have labeled them more clearly for you.

In giving you my personal estimate of inflation for the next four quarters, I would say that some members of the FOMC would be on the lower side and some on the upper side of the estimate, but I think I have captured most of the views within my personal range of 7 to 7¾ percent. I do not think there is any significant difference of opinion.

Inflationary pressures include not only the rate of price advances, but the condition of credit markets, and other factors. My statement was meant to give a broader outlook on inflationary pressures. I'm sorry to have been inexact, and will try to make the figures clearer next time.

Mr. WYLIE. Thank you very much. I appreciate your explanation. To add to the problem in my own mind, the Congressional Budget Office just published a report which came out yesterday and I noticed it last night, and it says on page 26 the dilemma of the Federal Reserve with accelerating inflation on the one hand, and the prospect of a recession on the other makes the outlook for monetary policy particularly uncertain.

They offer two differential forecasts for the coming year, depending on whether the Federal Reserve lets short-term interest rates rise, and they say on page 30 of that report,

No one knows precisely how much higher short-term interest rates can go before the economy is greatly weakened. Historical experience suggests not much further.

They say that if the Treasury bill rate goes to 8.5 percent in late 1978, and then gradually declines in 1979, that there will be a recession in 1979. However, if short-term rates stay about where they are now, we could easily have 3 to 4 percent real growth in 1979.

I think my question comes down to this, Mr. Miller: What can Congress do to help the Federal Reserve in containing inflation so that interest rates can be kept from rising and the economy can be kept from going into a recession as the Congressional Budget Office predicts might happen if interest rates continue to rise?

Mr. MILLER. Mr. Wylie, our problem at the Federal Reserve is not so much one of uncertainty as difficulty—difficulty in steering down a narrow path. We will try to maintain restraints on inflationary pressures, on the one hand but, on the other, we hope to do so in a way that will not bring on a recession, which we do not believe would provide a solution.

Your specific question is what can Congress do to help contain inflation so that we will not experience increases in interest rates. Pressure comes from the demand for cars and houses in anticipation of inflation, from the fact that more money is needed to finance purchases in the face of inflation. What Congress can do is to look at the macrosituation and to exert the discipline on fiscal policy that will relieve inflationary pressures.

I must commend Congress—and commend the administration—for the fact that in the few months I have been in Washington, the plan for fiscal year 1979 was changed to a deficit of \$43.5 billion from a deficit of \$60.5 billion (or \$72 billion if you include off-budget borrowing). It would have put enormous pressure on interest rates for the Federal Government to pull \$72 billion out of the capital market; \$43.5 billion is still an enormous deficit, but it is a \$17 billion improvement over \$60.5 billion.

We are all worried and we all want to find the culprit, but I would like to pat Congress on the back—particularly for the leadership which came from a good many Members—and to pat the administration on the back because the plan has been changed to take off \$17 billion of pressure. That is an excellent contribution.

Now there are other things that can be done in the legislative area—such as a change in the minimum wage law, which would take a half a percent off inflation. I would like to see us defer the increase in social security tax scheduled for January 1 and take a year to study how to reform the social security system in order to

keep intact its financial integrity while reducing its cost. Congress has innovative ideas; it needs the time to put them in place. With those two items—the minimum wage and social security tax increases—you could take three-quarters to 1 percent off the rate of inflation next year. With discipline, with a few changes to eliminate the regulatory burden, and with an accelerated depreciation allowance to start the action on investment, we would have a dynamic pattern begin to change the outlook and expectation for inflation. When inflation is building, nobody thinks it will stop; but when inflation starts to abate, everybody thinks it will stop.

Mr. WYLIE. An excellent summation. Thank you very much. My time has expired.

The CHAIRMAN. Mr. Mitchell.

Mr. MITCHELL. Thank you very much, Mr. Chairman.

Chairman Miller, I asked the chairman of the committee to yield to me when he was questioning you and I want to make it very clear that my statement was in no way meant to question your integrity nor your desire to see an attack on structural unemployment. Rather, I think I was prompted to speak because I am not optimistic that you or this Congress will do very much about structural unemployment simply because of the policies we are pursuing.

In your statement you talk about a real GNP growth of somewhere between $3\frac{1}{2}$ and $3\frac{3}{4}$ percent, less than 4 percent. That is not going to open up the economy sufficiently so that we can attack structural unemployment. It simply cannot do it.

You talk in your statement about tightening fiscal policies. Indeed the Congress has moved swiftly and effectively in that direction. But when we tighten up fiscal policies, what do we do? We limit the program growth for those who are unemployed, program growth in training and job placement. Thus this policy is invidious to structural unemployment.

In your statement you talked about training, I realize the value of training to get people employed. On the other hand, I know that during World War II when we needed people, we took them from the fields of Georgia, the mountains of North Carolina, with clay on their feet, and we put them in defense industry. With 2 weeks' training they were an integral part of the industry.

I am not optimistic, because of Fed policy and the policy of this Congress, that we are going to do much about structural unemployment. Whether we want to make a direct correlation or not, the high-interest rates which are now prevailing probably act as a depressing factor on the economy of this country. If not a depressing factor, certainly those rates do not act as an expansional factor. And, if there is no expansion in the private sector, then you are not going to do anything about structural unemployment.

Reluctantly, I guess I have come to the conclusion that in light of the monetary and the fiscal policies being pursued by the Fed, by this Congress, and by the administration, that blacks and other minorities who are unemployed now are going to be sacrificed on the altar of economics in the name of the fight against inflation.

I sincerely feel that unless there is a radical change, a dramatic change, in the policies that the Federal Reserve, this Congress, and the administration pursue, that those unfortunates are going to

remain unfortunate and they will have done their best for the country by being sacrificed in the name of inflation.

I thank you. I yield back the balance of my time.

Mr. MOORHEAD. Mr. Neal—

Mr. MILLER. May I comment, Mr. Chairman?

Mr. MITCHELL. Yes, of course.

Mr. MILLER. I appreciate Mr. Mitchell's statement. I just want to add that personally, and speaking for the Federal Reserve, there is no desire and no intention to cause hardship in anyone. We are as concerned as anyone can be about the sad state of affairs in terms of the high unemployment for minority youth and for other groups in our society.

We have pursued wrong policies for perhaps a dozen years; they have built up problems. Our dilemma is that if we try to pursue employment policies and a higher rate of growth, the resulting inflation, would be such that, in my opinion, would have a recession very soon. And then we would have higher unemployment than we now have.

We are caught in this dilemma. For whatever reasons we have built up inflation over a dozen years. I have felt the answer is to try to manage the economy and contain inflation, and then target our actions on structural unemployment. Unfortunately, the Federal Reserve is not responsible for taking that kind of action, but I certainly would join in it and be happy to submit ideas toward stimulating more effective Government policy in reducing structural unemployment.

We have to run the economy so that we do not give hope and then take it away through a recession. We have to give hope that we will continue to solve this problem—both break the inflationary cycle and provide people with full and rewarding employment opportunities that allow them to grow and progress.

I think we have the same desire. We also have the same problem—how to shape our policies to get there.

Mr. MITCHELL. I am sorry, I yielded back the balance of my time—

Mr. MOORHEAD. Instead of recognizing Mr. Neal at this moment, I think in view of the vote, the committee should stand in recess for 10 minutes.

[Recess.]

The CHAIRMAN. The committee will be in order.

The Chair will recognize Mrs. Fenwick.

Mrs. FENWICK. Thank you, Mr. Chairman.

Good morning, Mr. Chairman; good morning.

I share with Congressman Mitchell this concern for the structurally unemployed. So far, we have not attacked that very successfully, to put it mildly.

I wonder if you feel that Comprehensive Employment Training Act money should be perhaps targeted specifically to structural unemployment: what training programs do you know of that would be useful other than educational, strictly educational, ones?

Do you count on the accelerated depreciation for investment in new equipment to produce the better productivity and increased jobs that might be offered if that accelerated depreciation allowance were instituted?

Mr. MILLER. Congresswoman Fenwick, let me answer that in two parts.

Mrs. FENWICK. Yes.

Mr. MILLER. The Government could use better application of funds to make the employment programs more effective. The CETA program has provided a substantial number of jobs, but the linkage between those jobs and permanent positions in the private sector has been too weak. The result has been a temporary help, but not a basic, fundamental correction.

The President has introduced a new program this year called the private sector initiative to provide moneys for jobs in the private sector.

Mrs. FENWICK. How would that be done, Chairman Miller? Would that be done through tax credits to the firms that hire them, or how?

Mr. MILLER. This would be done by using CETA funds.

Mrs. FENWICK. Yes.

Mr. MILLER. \$400 million of CETA funds on an experimental basis.

Mrs. FENWICK. Right.

Mr. MILLER. There would be local industry councils set up in each community so that business and labor and community input would identify people who are in need of help—those who are among the hard-core unemployed, if you will—and develop the linkage to bring them into permanent private sector jobs. There would be a phased operation. The initial phase—

Mrs. FENWICK. I see.

Mr. MILLER. The initial phase would be federally funded and then, as people become fully trained, the probability of their continuing as employees in the private sector—where their services will continue to be needed—is much higher.

Mrs. FENWICK. Would it be kind of on-the-job training with supplementary wages paid?

Mr. MILLER. It is a new form of on-the-job training, but without some of the mechanism of on-the-job training that has often impeded smaller firms. You see, many of the job opportunities for the structurally unemployed exist in smaller firms which have a much harder time organizing official training programs and getting on-the-job training funds.

Mrs. FENWICK. Right.

Mr. MILLER. This is a new effort to try to spread the funds and training around. I think it is an initiative on the right track. It remains to be seen whether it can be implemented. I hope it will be implemented very vigorously, because if it is, it will break new ground in terms of getting this linkage between training and private sector jobs. It will put assistance for job training where the jobs are. It is not a parking place from which you cannot find the way out into the real action.

Mrs. FENWICK. Exactly, yes.

Mr. MILLER. Now, on your second point, which had to do with training?

Mrs. FENWICK. No; what effect do you think the accelerated depreciation will have on new employment?

Mr. MILLER. Accelerated depreciation?

Mrs. FENWICK. Yes.

Mr. MILLER. Accelerated depreciation, in my view, would create the opportunity for a long period of expansion in capital investment, which would add jobs to the market.

Mrs. FENWICK. I see.

Mr. MILLER. If we started a long-term program of increasing the amount of money we invest in business fixed investment to 12 percent of GNP—if we created the climate to do that—then those industries which supply production equipment and construct facilities would show a tremendous increase in demand for labor. The process itself would increase the general level of private sector employment in the country.

Mrs. FENWICK. I notice my time has expired so maybe you cannot even answer that, but I would like to pose it so that maybe somebody else could.

In this matter of the rise in the social security tax, which I think is one of the greatest inhibitory things against employment that could possibly have been done, would this be in your opinion destructive if we include general tax funding as part of the social security program to make it viably sound?

Mr. MILLER. I would be very concerned about an actuarially sound system of social security being funded out of general revenues. The tendency would be for one Congress to be pressured into giving out benefits knowing that another Congress—many years later—would have to pay the ticket.

Mrs. FENWICK. I see.

Mr. MILLER. Unless we preserve the financial integrity of the system, we run the risk—out of wanting to be generous, wanting to be helpful—of leaving our heirs with an impossible debt burden they could not cope with. So I am opposed to general revenue funding for social security retirement benefits. But a deferral for 1 year would give the time to study how to change benefits in a way that maintains financial integrity in the funding of the system.

Mrs. FENWICK. Medical dependency, for example?

Mr. MILLER. Let's look at some of the nonactuarial aspects of the social security system, such as medicare, differently.

Mrs. FENWICK. Exactly.

Thank you.

The CHAIRMAN. The Chair now recognizes one of our local heroes of the week, Mr. Neal, who piloted a very difficult Export-Import Bank bill through yesterday; ranking with such as Mr. Moorhead as to New York City and Mr. St Germain as to bank regulations and co-ops and others.

Mr. NEAL. Thank you, Mr. Chairman.

Mr. Chairman, I was reviewing the most recent Federal Reserve bill that we passed here in the 95th Congress and, under the general policy provisions of that bill, it says, and I quote:

The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long-run growth of the monetary and credit aggregates commensurate with the economy's long-run potential to increase production.

Now the word "commensurate" is a word which means of the same size, extent or duration or corresponding in scale or measure,

proportionate, or having a common measure or standard, and so on. It seems to me to be a precise word.

In looking at the Fed's policy over this last year, we find that the rate of growth in the M_1 money supply has been over the target all year. The target range, as I remember, was 4.5 to 6.5 percent on average for the year; it has been 8 percent. This latest month I think it was 7.5 percent, or something like that.

I have become convinced that there is nothing in the world more inflationary than printing more money than the economy can accommodate, and yet I believe the Fed is printing more money than the economy can accommodate.

I believe that we are going to pay a high price for that over the next few years, and for as long as the Fed prints more money than the economy can accommodate, we are going to pay a high price for it.

It seems to me the law requires that the Federal Reserve not do that. I would like for the Chairman to comment on whether he agrees with my interpretation of the law, and whether he would want to see us slow down the rate of growth in the money supply and keep it within the targets announced by the Federal Reserve and approved by this committee earlier in the year.

Mr. MILLER. Certainly, Congressman Neal, the record of performance on M_1 in relation to the ranges established by the FOMC has been a poor one over the last 18 months. It is desirable not only that the FOMC set ranges, but intend to live within them. I think that is a fair comment.

But we do have a dynamic economy in which the payments systems are changing and in which the higher general level of interest rates that we have experienced for some time now has, perhaps, changed the concept of money management. This has made it hard for the Federal Reserve to predict the range of this narrow aggregate as our actions work their way into a changing economic stream.

I accept your general proposition. Our job has been to try to turn the growth of M_1 down at a measured pace so as to get it back into the growth range that the committee believes is consistent and appropriate with assuring the best opportunity for full employment with price stability.

I can only point out that I do not think that the score card for the Federal Reserve should be limited to one narrow, volatile measure. Nor would it be wise to crunch the economy at any particular time and bring on a recession merely because it is desirable, long term, to starve down the money supply and to starve down inflation. The question of timing, of degree, is now important.

M_2 and M_3 have been maintained within their ranges. In recent months, we have tightened credit quite a bit. My fear has been that if, in order to bring M_1 down, we tightened more rapidly than we have since last March when I came here, we would create short-term dislocations that would not help us solve our long-term problem.

A recession would have to be very deep and very long to have much impact on the kind of inflation we are suffering from now. We then would have to ask ourselves, "Is that tolerable? Can we maintain it? Is it desirable?"

The answer seems to me to be no. Therefore, our other choice is to continue to move the growth of aggregates in the right direction—to turn them down and get them back, over time, into the proper ranges. As I mentioned in my testimony, over time I am sure you would like and we would like to bring them down so we can wring inflation out.

Mr. NEAL. My time has expired.

The CHAIRMAN Thank you, Mr. Neal.

Mr. Derrick.

Mr. DERRICK. Thank you, Mr. Chairman.

Mr. Miller, I think this is the fourth morning this week we have been together and I have learned a great deal.

Mr. MILLER. I am having a good week, yes.

Mr. DERRICK. Let me say that I think your response to Mr. Wylie's question on the matter of inflation is the most positive one that I can recall having heard. And I, too, am pleased that it appears that we may get the deficit down to around \$42 to \$44 billion, somewhere in that neighborhood.

We are now, as you know, marking up the second budget resolution. Also, Secretary Solomon over at Treasury yesterday announced we were making significant progress in the cut-back of imported crude oil, I think running about a billion barrels less, or million, I have forgotten—

Mr. MILLER. A million barrels a day less?

Mr. DERRICK. Million—a substantial amount, compared to last year. So those are two significant, I think, steps in the right direction.

My question to you is this: The third major cause is gouging, I think, in the private sector. Do you see anything that we might do here in the Congress to encourage maybe a slow-back on that in the private sector?

Mr. MILLER. Slow-back on what?

Mr. DERRICK. On the gouging in the private sector.

Mr. MILLER. Well, I have—

Mr. DERRICK. Assuming that you think that is one of the causes. Maybe you do not.

Mr. MILLER. About 80 percent of the goods and services are produced in the private sector, and that is where the price increases are. Many of the price pressures, such as those that arise from commodities, and food—and food has been a very bad performer—are the natural consequence of supply and demand.

Our current account deficit has caused pressure on the dollar. A reduction in our oil imports, which you mentioned, is the kind of progress we need. As far as the private sector is concerned, I have been somewhat disappointed in its level of response to the President's deceleration program; it has been inadequate so far and is disappointing.

The private sector has a tremendous self-interest in helping to bring about a decline in inflation, and it should have the discipline—all of us are trying to bring discipline to our areas—to be more constrained, because short-term gains are not going to be worth anything. In the long term, they are going to make less profit and have less real income. If the private sector would accept

less now, then I think it will make more profit and have more real income.

I do not know what the Congress could do to aid the deceleration program. It probably needs a second phase in which far more emphasis—and perhaps more intensity of action—is placed on the components of the economy that have the most influence. If we spread ourselves too thin I guess we get too little done. Maybe there should be a concentrated, high level program on basic industries.

I am not sure I can add much. I am trying to see how to bring discipline to monetary and fiscal policies, but I have not been active in the private sector initiative recently; that has been handled by the administration. So I do not have much to add except to say I'm disappointed in results so far.

Mr. DERRICK. Thank you very much.

Earlier this year I think you stated that you felt that interest rates would weather the supply of money in the housing market, would probably become a little more plentiful toward the end of this year, but you did not see a substantial decrease in long-term interest rates. Do you feel that is still holding pretty steady?

You made a comment earlier that I missed, and I am sorry I did, concerning the housing industry.

Mr. MILLER. Let me just refer, for a moment, to the interest rate chart in my testimony. I think it is worth looking at.

Chart 5, shows you the kind of periods we have been through. In 1974, we had double-digit interest rates; the line that you see at the top labeled "triple A utility bonds" gives a proxy of long-term interest rates; the lines below—the 3-month Treasury bill, the prime commercial paper—give a view of the short-term rates.

We could not plot all the rates; it would be too busy a chart. What you do see is that, with a recession—and the shrinking of demand and the increase of liquidity—interest rates came down. They trended down for long-term rates and they came down very sharply for short-term rates.

Now, as there have been constraints on credit—because of existing demands for credit and borrowing by the Government—short-term rates have been rising. There has been a flattening of the yield curve. Long-term rates have gone up, but not as much as short-term rates.

The important thing is that if the expectation of inflation and inflationary pressures are changed we will begin to see a leveling off of these rates, their topping off.

The first sign that we are moving into more comfortable territory—getting over this fevered period—would be for short-term rates to begin to decline. Long-term rates, as you notice during the earlier period, would lag and would then begin to trend downward.

Mr. DERRICK. My time has expired.

Mr. Chairman, may I interject just one thing before I finish?

The CHAIRMAN. Without objection; yes.

Mr. DERRICK. Do you think the proposed, the expected decrease in deficit by some \$16 or \$17 billion might play a significant part in this toward the end of the year, or the first of next year?

Mr. MILLER. Yes. The Federal deficit in the fourth quarter of this year, and thus the demand for credit, would have been substantial-

ly higher without this new plan, so I think we are going to see a change in pressure from what it would have been.

Now I do not want to mislead you; we are still going to have a difficult fourth quarter. The Treasury is going to need about \$25 billion of funds in the fourth quarter, much higher than the third quarter, just because of the seasonal aspects of debt financing.

Mr. DERRICK. Less than expected?

Mr. MILLER. It would have been about \$32, \$33, or \$34 billion if the tax cut had not been postponed. So there is a lessening of pressure, and that is encouraging indeed.

Mr. DERRICK. I thank you very much.

The CHAIRMAN. Mr. Brown.

Mr. BROWN. Thank you, Mr. Chairman.

Chairman Miller, it is nice to see you again today. Very fine statement. However, I think the most significant part of your statement, clearly the most accurate, is in about the third or fourth paragraph where you talk about the problem of inflation and then say:

Monetary policy has been and will continue to be designed to restrain inflation, but monetary policy cannot do the job alone. Placing too great a burden on monetary policy would entail dangers of severe financial dislocation that could have unfortunate longer run consequences for the domestic and international economies.

After hearing your testimony this morning and yesterday, I wonder does anybody listen to you downtown?

Mr. MILLER. Well, I—

Mr. BROWN. I will not ask you to answer that question.

Mr. MILLER. I believe I will take the fifth.

Mr. BROWN. Obviously our deeds do not match our rhetoric.

There have not been anti-inflation efforts. You mentioned things that could be done were we to get out front in the way of fiscal policy, the postponement of the increases in the minimum wage, postponement as you have advocated of the social security tax increase and certainly we can do something about regulatory over-kill.

The two or three times the President recently had an opportunity to make the decision on whether to opt for heavy regulatory operations by an agency which would be much more inflationary than an alternative, he has opted for the excessive regulatory activity.

What has he done on the other side of the equation, the proinflation things that have been suggested by this administration? Oil import fees, crude oil equalization tax, and—thank God it was killed—the cargo preference bill. I could go on and on.

We talk about doing things about inflation but when we get up front it seems that the up-front things are primarily proinflation rather than anti-inflation.

Let me just—I will not ask you to comment, I just wish that there were more listening to you and certainly Secretary Blumenthal agrees with you on the minimum wage, so does Arthur Okun, and certainly he is not exactly a far right economist. What do you think about the tax package just passed last night, or put out by the committee?

Mr. MILLER. I have not had a chance to look at it in detail, but my reaction is that, in terms of using the available amount for tax cuts capital gains reforms are not the best way to go at this time.

I have felt that incentives which would bring about conditions for increased business investment, which would increase productivity—

Mr. BROWN. Can we have some order, please? I am having a difficult time hearing the chairman.

Mr. MILLER. Excuse me. I was saying that if the Congress decides that \$15 billion—or \$19 billion now—is the right level of tax cut, and the question is how to allocate that tax cut, I would prefer to take that which was allocated to reduction of capital gains under the bill reported out yesterday and allocate it to direct incentives for business investment.

A change in capital gains—while maybe desirable and maybe deserved—for the purpose of increasing the incentive for capital investment saving, and capital formation, should be made at a later time, when we have already turned the corner on what I think are the fundamental issues. You mentioned some that I have already pointed out.

But productivity has been so low, and the continuing chase—prices going up, wages going up to catch prices, prices going up to pass on wage increases—is a vicious one. The only way I know to break the cycle is to increase productivity so that increases in compensation do not show up in increases in costs, so that they are offset, to a degree by higher productivity. I believe that requires a major thrust in stimulating investment.

Mr. BROWN. You mentioned accelerated depreciation. Do you subscribe to that which has been suggested, a schedule that seems to have the most consensus, that mandatory or mandated equipment purchase be able to be written off in the first year, other equipment 5 years, and structures 10 years?

Mr. MILLER. I agree with that proposal.

Mr. BROWN. Would you prefer that to any kind of an indexing on the basis of replacement?

Mr. MILLER. It would do more good for more people for a longer period of time to adopt such a reform than to change the capital gains tax rate at this time.

I am not opposed to some reform in capital gains, but I think it should be done later. The outline you have just presented—a 1-year writeoff for mandated pollution control or safety equipment, a 5-year writeoff for equipment and a 10-year writeoff for structures—would go a long way toward moving us in the right direction. It would both maintain growth in the economy in an area where there is less chance of inflation, and also contribute to reducing costs, to breaking the spiral of inflation, to improving our competitiveness in the world, and to improving the opportunity for exports. A whole number of good things would flow out of that policy.

Mr. BROWN. Thank you very much, Mr. Chairman. My time has expired.

The CHAIRMAN. Mr. Blanchard.

Mr. BLANCHARD. Thank you, Chairman Reuss.

Welcome again to our committee, Chairman Miller.

Mr. MILLER. Thank you.

Mr. BLANCHARD. You have touched on it several times. I would just like a clarification. You commended Congress and the President for moving the deficit down some \$17 or \$18 billion from what it would have been, about \$60 to maybe \$42 or \$43 billion.

I notice in your testimony in dealing with various ways to fight inflation, you do indicate a significant reduction in the Federal budget deficit would be an important first step.

Taking your comments together, are you saying that that \$17 or \$18 billion is the significant thing you recommend or would you recommend even more?

Mr. MILLER. I believe that \$17 billion is quite satisfactory at this stage. I used the word "would" because when my testimony was written, we were still looking at proposals; we had not seen the reduction locked into a budget resolution yet. If it is locked into a budget resolution, a deficit in the low forties for fiscal year 1979 would be just about right.

I would like to see us reduce the Federal deficit on a gradual basis that does not cause too quick a jerk in the economy—that allows for smooth adjustment—so that we can keep the economy growing for several years. If we can get the deficit to the low forties in 1979, to the low thirties or below in 1980, to a \$15 billion range in 1981, and bring it into balance in 1982 with full employment, that trend would not cause any abrupt change in the economy. It would be a responsible program and a desirable one.

Mr. BLANCHARD. That is helpful.

The only other question I have relates to repurchase agreements. There are some who feel that in circumventing the 1935 prohibition against paying interest on demand deposits, banks have used repurchase agreements which essentially for periods of time convert demand deposits to loans and then, I guess the theory would go, and I do not know enough about it to tell you it is my theory, the theory would go that M_1 is understated because of this fact, and, therefore, maybe decisions by the Fed would not be as well-considered.

Do you have any comments on that theory?

Mr. MILLER. M_1 is a very narrow measure of money, as I have indicated several times. We have to be careful not to believe that it measures everything; it does change for technical reasons.

When treasurers of enterprises face high interest rates, they have to consider the opportunity—cost of money and they are very clever in how they use their funds. If banks did not have repurchase agreements, I am sure they would find other ways to invest their money overnight.

So the point I would make is that there are certainly changes taking place as households and businesses manage their cash differently. Some of them work to underestimate M_1 and some to overestimate it. We have to find better measures and keep an eye on the broader picture.

For example, for all practical purposes, anybody holding Treasury bills is holding cash. You can convert bills to cash in 15 minutes yet they are not measured in any of our aggregates. So there are many complex issues to be looked at.

Mr. BLANCHARD. So you think with the repurchase agreement phenomenon, we have understated money growth?

Mr. MILLER. No. Money will always be finding places to earn a yield. That particular technique has not by itself contributed any distortion; a whole range of new money management techniques has, however.

Mr. BLANCHARD. You mentioned the Treasury bill situation. Are there transactions and elements that perhaps should be counted that are not counted now in M_1 , M_2 , and so forth?

Mr. MILLER. The definition of money needs to be changed as techniques change.

I am not suggesting that we could not have M_1 through M_7 —go all the way to bank credit—and accommodate to changes. Nevertheless, as we try to develop a better mechanism and a better understanding, we have to keep in mind the process used in the past. We should not just adjust to transitory influence.

The process of change will continue and we have to keep evolving a better way to get a handle on the money supply. We can't think we are all set just because we suddenly change a definition.

Mr. BLANCHARD. Finally, I want to thank you and commend you for all the time you have shared with us. I have sat on this committee 4 years and found that previously it was very difficult to get answers, even though our witnesses were obviously well-informed. I appreciate it and want to thank you.

Mr. MILLER. Thank you.

[Written question for Chairman G. William Miller of the Federal Reserve Board, submitted by Representative James J. Blanchard for inclusion in the record of the quarterly hearings on the conduct of monetary policy before the Committee on Banking, Finance and Urban Affairs, July 28, 1978]

I want to follow up our colloquy on repurchase agreements between banks and their large corporate customers.

In the second meeting on the Conduct of Monetary Policy for 1978, held on April 24 of this year, Dr. Donald Hester, professor of economics at the University of Wisconsin, testified that the Federal Reserve may be undercounting M_1 because of repurchase agreements. Repurchase agreements are advantageous both to banks and their customers. Through these agreements, banks convert reservable deposits into loan liabilities that are not subject to reserve requirements; customers get interest. Professor Hester stated that under repurchase agreements, as currently often negotiated, "the seller of funds does not have to deliver funds until near the close of a business day * * *. Therefore funds acquired through repurchase agreements are not counted as money even though they may have been used that way all day."

Last Friday, I asked if you thought that repurchase agreements had resulted in the understatement of money growth. Your response was "No. I think the money would * * * get yields regardless of the particular technique. That particular technique I do not think has by itself contributed to any distortion."

You went on to say "take anybody holding Treasury bills, for all practical purposes that is cash. You can convert them in 15 minutes to cash. Yet that is not even measured in any of our aggregates."

It seems to me, however, that Treasury bills and repurchase agreements, at least overnight agreements, have fundamentally different implications for money supply. If I sell a Treasury bill, true I get cash but the buyer gives up cash, unless the buyer is you—the Fed. In other words, transactions in Treasury bills have no money supply effects unless the Fed is the buyer or seller. So it would be wrong to count Treasury bills as money. On the other hand, an overnight repurchase agreement between a bank and one of its customers has direct impact on the quantity of deposits which is included in the money supply. It reduces that quantity by the amount of the repurchase agreement. Consider an agreement by a bank to borrow \$100 from a customer overnight, from the close of business on Monday to the opening on Tuesday. At the close of business on Monday, \$100 in deposits becomes a loan. At the opening on Tuesday, it again becomes a deposit. Surely it is a mistake

not to count the \$100 as M₁ deposits even though they are carried on the books as loan liabilities. The \$100 is every bit as much part of the public's transactions balances as demand deposits on the books at the close of business on Monday.

I would appreciate your further comments on this matter, to resolve what appears to be a discrepancy between your statements to me and Professor Hester's testimony to Senate Banking. Additionally, I would like information on the volume of repurchase agreements by maturity—overnight, 2 days, all others—by quarter from 1970 to date.

[Chairman Miller subsequently furnished the following response for inclusion in the record of the hearing before the House Committee on Banking, Finance and Urban Affairs held on July 28, 1978, in answer to a question submitted to him in writing by Congressman James J. Blanchard:]

The experience with high interest rates in recent years has made money holders acutely aware of the opportunity cost of holding their money balances in non-interest earning form. This awareness has resulted in more widespread application of cash management techniques—especially by businesses and governmental units—in the period since 1973 and 1974. Some of the funds released from demand deposits no doubt have been used to acquire highly liquid interest-earning assets—including repurchase agreements (RP's). While the apparent rapid growth in RP's in some recent years has likely been associated with somewhat slower growth in demand deposits than was expected on the basis of historical experience, RP growth has been a symptom of a shift in the demand for M₁, and not the primary cause.

Repurchase agreements are considered by many to be no more liquid than Treasury bills. Treasury bills can usually be bought or sold easily throughout the course of a business day, so that a bill can typically be converted to cash at any time during the regular business day. On the other hand, once an overnight RP is arranged with a bank—generally during the morning—these funds are committed until the next business day.

The implications for the rate of growth of the money stock are basically the same regardless of whether the public attempts to convert undesired amounts of demand deposits into Treasury bills or RP's. In the case of a shift from demand deposits to RP's, the impact is direct—as banks increase RP liabilities and correspondingly debit demand deposits. On the other hand, a shift from demand deposits to Treasury bills is more indirect—unless the seller of the bill is a commercial bank—arising as the Desk responds to the unexpected downward movements in money market rates by selling bills in exchange for deposits in the open market.

It should be emphasized that the fact that a bank acquires funds under an RP arrangement does not mean that these funds are, in effect, demand deposits under another form or name. If the lender were unable to make the RP arrangement with the bank, he very likely would have withdrawn the funds from the bank and placed them in an RP with a nonbank dealer, in Treasury bills, or in very short-term commercial paper. The bank's demand deposits would, therefore, have been no different in volume whether or not the bank made the RP. But if the bank makes an RP, it does have more funds for lending—just as it does if it issues additional negotiable certificates of deposit to business or state and local government customers. (Attached is a public release containing RP maturity information for two special surveys of 46 large banks, taken in April 1974 and December 1977; these surveys are the only data available with a detailed breakdown of RP's by maturity.)

REPURCHASE AGREEMENTS AND OTHER NONRESERVABLE BORROWINGS IN IMMEDIATELY AVAILABLE FUNDS

During the 7 days ended December 7, 1977, the Federal Reserve System conducted a special survey of gross borrowings in immediately available funds by 46 large member banks. The survey obtained detailed information on the source and maturity distribution of these borrowings and also distinguished between borrowings in the form of repurchase agreements involving U.S. Government and Federal agency securities and other forms of borrowings in immediately available funds. Aggregate data from the survey are presented in the accompanying tables.

A similar survey, conducted in April 1974, provided a basis for comparing changes in these sources of funds over time. Aggregate data from that survey are also shown in the tables. Only 45 of the 46 large member banks, however, participated in the 1974 survey.

The tables contain 7-day averages of the dollar amount of outstanding borrowings reported during the survey week. In addition, all data were reported on a gross

basis, that is, not netted against loans made to the same institutions. Neither deposits nor other obligations subject to reserve requirements or interest rate limitations under Federal Reserve regulations D, Q, or M were included.

The first table provides detailed maturity information on both repurchase agreements and other forms of nonreservable borrowings in immediately available funds. The second table combines the two forms of borrowings in a format similar to that of the 1974 survey, which is shown in the third table.

Due to modifications in the 1977 reporting format, certain differences exist between the two surveys in the degree of detail obtained. While separate lender categories for savings and loan associations and savings banks were reported in the 1974 survey, these institutions were combined into "other depository institutions" in the 1977 survey. Similarly, Federal Home Loan Banks and other agencies of the U.S. appeared separately in 1974, but were combined into a single item on the 1977 survey. In addition, credit unions and financial businesses were reported separately in the 1977 survey. These institutions had previously been combined in borrowings from "all others" and "business corporations," respectively, in the 1974 survey. The maturity distribution was also modified in 1977 to include the combination of borrowing in maturities of 30 to 90 days and over 90 days to 7 years, previously reported separately in the 1974 survey.

The following definitions may be useful in interpreting the tables:

Immediately available funds.—Often called "Federal funds," these are funds that a bank can either use or dispose of on the same business day as the transaction is executed, giving rise to the receipt of funds.

Repurchase agreements.—These transactions involve the sales of securities to a customer under an agreement to repurchase the same or similar securities at a later date. For purposes of these surveys, only repurchase agreements involving U.S. Government or Federal agency securities were reported in the repurchase agreement section.

Other forms of borrowings.—These include all other borrowings in immediately available funds, whether secured, unsecured, or in the form of repurchase agreements on other securities or assets of the bank.

Maturity.—"One-day" borrowings consist of all borrowings for one business day that mature on the next business day, including borrowings on Friday to mature on Monday.

Continuing contracts.—These transactions reflect borrowings that remained in effect for more than one day but that had no specified maturity and did not require advance notice by lender or borrower to terminate.

Other maturities.—These categories were defined in terms of calendar days, not business days.

FOR STATEMENT WEEK ENDED DECEMBER 7, 1977

Table 1

REPORT OF GROSS NONRESERVABLE BORROWINGS IN IMMEDIATELY AVAILABLE FUNDS
7 DAY AVERAGE DOLLAR AMOUNTS (MILLIONS)
(46 Banks)

	MATURITY					
	TOTAL	1-DAY	CONTINUING CONTRACT	2-7 DAYS	8-30 DAYS	OVER 30 DAYS BUT LESS THAN 7 YEARS
I. RP'S ON U.S. GOVERNMENT AND AGENCY SECURITIES						
A. Member commercial banks	2,803.5	1,541.1	170.1	358.7	427.8	305.8
B. Nonmember domestic commercial banks	255.8	147.2	23.2	27.7	26.2	31.5
C. Branches and agencies of foreign banks operating in U.S.	38.6	25.1	.0	13.5	.0	.0
D. Edge Act and Agreement corporations	40.6	29.4	.0	10.1	.4	.7
E. Other depository institutions	77.8	59.1	.1	12.4	1.4	4.8
F. Agencies of the U.S.	403.5	385.1	.0	7.8	7.1	3.5
G. Securities dealers	1,976.1	397.5	248.4	215.4	608.4	506.4
H. Credit unions	61.9	32.4	.8	18.0	.0	10.7
I. Financial businesses	1,701.7	1,042.0	155.2	303.4	160.0	41.1
J. All other businesses	10,472.4	3,256.8	1,198.5	2,203.1	2,913.0	901.0
K. State and local governments	3,787.7	2,188.8	144.5	432.2	681.2	341.0
L. Foreign banks and foreign official institutions	323.0	225.7	.0	58.1	37.4	1.8
M. All others	248.4	150.8	16.7	37.4	33.5	10.0
TOTAL	22,191.0	9,481.0	1,957.5	3,697.8	4,896.4	2,158.3
II. ALL OTHER NONRESERVABLE BORROWINGS						
A. Member commercial banks	17,908.0	16,982.2	512.2	79.1	143.7	190.8
B. Nonmember domestic commercial banks	5,529.2	4,726.2	558.8	18.4	162.7	63.1
C. Branches and agencies of foreign banks operating in U.S.	2,190.3	2,135.2	1.8	1.4	4.1	27.8
D. Edge Act and Agreement corporations	210.0	181.5	.0	1.0	5.5	22.0
E. Other depository institutions	5,946.9	4,047.4	364.5	83.7	370.8	1,080.5
F. Agencies of the U.S.	2,245.6	1,983.4	.5	33.1	49.8	178.8
G. Securities dealers	1,889.2	1,889.2	.0	.0	.0	.0
H. All others	149.3	79.0	6.5	63.7	.1	.0
TOTAL	35,868.5	31,844.1	1,444.3	280.4	736.7	1,563.0

FOR STATEMENT WEEK ENDED DECEMBER 7, 1977

Table 2

REPORT OF GROSS NONRESERVABLE BORROWINGS IN IMMEDIATELY AVAILABLE FUNDS
7 DAY AVERAGE DOLLAR AMOUNTS (MILLIONS)
(46 Banks)

BORROWED FROM:	TYPE			MATURITY				
	RP'S ON U.S. GOVT. AND AGENCY SECURITIES	ALL OTHER	TOTAL	1-DAY	CONTINUING CONTRACT	2-7 DAYS	8-30 DAYS	OVER 30 DAYS BUT LESS THAN 7 YEARS
A. Member commercial banks	2,803.5	17,908.0	20,711.5	18,523.3	682.3	437.8	571.5	496.6
B. Nonmember domestic commercial banks	255.8	5,529.2	5,785.0	4,873.4	582.0	46.1	188.9	94.6
C. Branches and agencies of foreign banks operating in U.S.	38.6	2,190.3	2,228.9	2,180.3	1.8	14.9	4.1	27.8
D. Edge Act and Agreement corporations	40.6	210.0	250.6	210.9	.0	11.1	5.9	22.7
E. Other depository institutions	77.8	5,946.9	6,024.7	4,106.5	364.6	96.1	372.2	1,085.3
F. Agencies of the U.S.	403.5	2,245.6	2,649.1	2,368.5	.5	40.9	56.9	182.3
G. Securities dealers	1,976.1	1,689.2	3,665.3	2,086.7	248.4	215.4	608.4	506.4
H. Credit unions	61.9	.0	61.9	32.4	.8	18.0	.0	10.7
I. Financial businesses	1,701.7	.0	1,701.7	1,042.0	155.2	303.4	160.0	41.1
J. All other businesses	10,472.4	.0	10,472.4	3,256.8	1,198.5	2,302.1	2,913.0	901.0
K. State and local governments	3,787.7	.0	3,787.7	2,188.8	144.5	432.2	681.2	341.0
L. Foreign banks and foreign official institutions	323.0	.0	323.0	225.7	.0	58.1	37.4	1.8
M. All others	248.4	149.3	397.7	229.8	23.2	101.1	33.6	10.0
TOTAL	22,191.0	35,868.5	58,059.5	41,325.1	3,401.8	3,978.2	5,633.1	3,721.3

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Table 3

REPORT OF GROSS NONRESERVABLE BORROWINGS IN IMMEDIATELY AVAILABLE FUNDS
7 DAY AVERAGE DOLLAR AMOUNTS (MILLIONS)
(45 Banks)

BORROWED FROM:	TYPE			MATURITY					OVER 90 DAYS BUT LESS THAN 7 YEARS
	RP'S ON U.S. GOVT. AND AGENCY SECURITIES	ALL OTHER	TOTAL	1-DAY	CONTINUING CONTRACT	2-7 DAYS	8-29 DAYS	30-90 DAYS	
A. Member commercial banks	1,001.7	13,083.7	14,085.4	11,404.1	1,421.7	234.8	182.0	456.8	385.8
B. Nonmember domestic commercial banks	455.4	3,889.4	4,344.8	2,827.0	1,347.7	69.5	30.4	56.1	14.0
C. Branches and agencies of foreign banks operating in U.S.	.1	3,183.1	3,183.2	2,347.0	72.8	44.0	209.2	350.1	160.0
D. Edge Act and Agreement corporations	28.7	116.2	145.0	95.5	6.5	.0	4.2	38.5	.0
E. Savings and loan associations and cooperative banks	64.0	2,889.4	2,953.4	1,766.5	511.1	97.4	131.5	370.5	76.1
F. Savings banks	7.2	1,643.5	1,650.8	1,198.5	432.5	4.1	.2	14.0	1.2
G. Federal Home Loan Banks and Board	6.8	1,173.0	1,179.8	680.0	5.8	6.4	147.5	240.4	99.5
H. All other agencies of the U.S.	235.8	483.1	719.0	367.8	6.0	100.1	59.2	50.7	135.0
I. Securities dealers	941.1	66.4	1,007.5	136.7	93.5	133.0	245.5	368.4	30.2
J. Business corporations	2,110.4	.0	2,110.4	1,013.8	190.5	452.7	349.7	88.8	14.7
K. State and local governments	3,033.2	.0	3,033.2	1,240.0	181.1	429.7	482.5	490.7	209.0
L. Foreign banks and foreign official institutions	613.4	.0	613.4	342.5	165.5	31.2	67.0	7.0	.0
M. All others	235.0	.0	235.0	76.1	43.8	50.0	39.2	24.7	1.0
TOTAL	8,733.2	26,528.1	35,261.4	23,496.0	4,479.1	1,653.4	1,948.8	2,557.1	1,126.8

The CHAIRMAN. Mr. Hannaford.

Mr. HANNAFORD. Yes, Mr. Chairman. I always enjoy having you with us and appreciate your openness and availability here and otherwise making yourself available to us.

On page 8, Mr. Chairman, you say that members of the committee, Open Market Committee, differed somewhat in their appraisal of the outlook.

Now I have an interest in restoring the minutes of these committee meetings and releasing them at some time, 1 year, 3 years, 5 years, whatever is the appropriate time. Do you not think that these differences that you allude to here might not be instructive or might be instructive to future policymakers and scholars who become guides to policy?

Mr. MILLER. Congressman Hannaford, I do think it would be healthy to reestablish procedures for publishing minutes. Your efforts and your interest in this area are to be commended; I share your opinion.

The problem we have is that if minutes were now to be taken, they would be subject to release under Freedom of Information. It would be very hard to run an FOMC meeting if individuals were leery of expressing their opinions openly for fear that next week they would be held to explain a transitory position.

If we could find a way to exempt such records from Freedom of Information—and publish them after some delay in time—we could make a real contribution to the understanding of future policymakers and to improvement in the process of decisionmaking.

Mr. HANNAFORD. I appreciate that. I think the problem can be worked out. I will be contacting you in an effort to do that.

Mr. MILLER. We would be glad to work with you because we have a common interest; we could all gain from doing that.

Mr. HANNAFORD. Thank you.

Mr. Chairman, it was said a while ago that we are not doing anything to stop inflation, but that might have been something of a partisan remark. I will respond in a partisan fashion and say that our reduction from a \$60-plus billion deficit to \$42 billion deficit is not too bad a step, as you have said more recently.

There are a couple of disciples on the other side of the aisle proposing a much larger deficit in something that is called the Kemp-Roth bill that I understand would substantially excite the demand curve of the equation something like a \$100-billion deficit.

It is my understanding that you would propose, and what you have said on taxes here, in a much more restrained way, try to treat the supply side.

It is my view that those who want to fight inflation on the other side of the aisle should look at a more restrained growth in the supply side, and a much more restrained increase in demand. Can you comment on that?

Mr. MILLER. I feel the Kemp-Roth proposal is inappropriate; it would add to inflationary pressures. It would, of course, increase the Federal deficit—which would add to our problems at the Federal Reserve—and also contribute to inflation.

I have no objection to transferring resources from the public sector to the private sector. Over a 5- or 7-year period, we should

reduce Federal expenditures as a percent of GNP—from the 22 percent or more they are now, down to about 20 percent.

Up until 1965, Federal expenditures as a percent of GNP were always below 20 percent; so, it would not be revolutionary to do that.

Now, if we did that, then as we cut expenditures we could cut taxes—without increasing the deficit. If the principal interest is to return decisionmaking to individuals and businesses by reducing their taxes and reducing Government, we should reduce Government expenditures first and then make tax cuts, rather than the reverse.

That is the only way to avoid increasing inflationary pressures and working against our goal.

Mr. HANNAFORD. Our efforts to get the deficit down to \$42 billion is some movement in the direction of what you have suggested.

Mr. MILLER. Absolutely.

Mr. HANNAFORD. We have an unemployment rate now of 5.7 percent. A very large ingredient of this is the structural unemployment that we have talked about.

I wonder how close we are to inflationary pressures as a result of the low rate of employment for the skilled and the professional person, and how much you are influenced by your wanting to slow the rate of growth in order to assimilate the relatively unemployable, that perhaps we are fairly close to full employment in an effective sense, and that our job is to try to grow in such a way as to assimilate the relatively unemployable.

Mr. MILLER. In terms of both industrial capacity and labor availability in certain skills, and in terms of certain geographical areas, we are at a point where we must be very careful not to trigger demand-pull inflation along with our present cost-push inflation.

I think you are correct. We cannot but take note of the human needs of those who are unemployed in certain areas of the country, or of unskilled youth and minorities.

That is why targeted programs are far superior than the medicine of macroeconomic policy, which would certainly run us into demand-pull inflation and merely make our problems worse.

So we have a very serious dilemma. We need to look at the welfare of individuals and of our Nation, not just from today's point of view, but over the long term. Over the long term, we will all be better off by getting rid of inflation.

Short term we have to take special measures to try to cure inflation and to try to cure structural unemployment.

Mr. HANNAFORD. Mr. Miller, I thank you. Five minutes passes awfully fast when conversing with you.

The CHAIRMAN. Thank you, Mr. Hannaford.

Mr. Grassley?

Mr. GRASSLEY. Thank you, Mr. Chairman.

Mr. Miller, I would like to carry on the colloquy that you had with Mr. Neal about five questions ago.

You said in your statements generally that the growth rates of M_2 and M_3 are within their ranges. But you go on to say that this is because money is going into things like Treasury securities that are not counted within those aggregates.

The implication seems to be that monetary aggregates are really accelerating, and only some structural shifts keep our measurements from showing that. So, the rapid expansion in M_1 over the last few months is not an aberration.

If all this is so, how can we talk about tight money? It seems that on the contrary, the Fed has been quite liberal in supplying reserves to the banking system.

Mr. MILLER. Money growth in recent periods has certainly been undesirable. Our effort is to restrain it and to bring the growth rate back into our range.

Our problem, of course, is one of how fast we can tighten and how much tightening can we do to bring M_1 into a growth range that will reduce inflationary pressures, without bringing a disruption in the economy.

That is why I have tried to say that the only way we can work successfully is to bend inflation in the right direction and keep it in the right direction. We can't hope to change it in 2 months; that would be so disruptive to the economy that there would be a quick withdrawal of credit resources, and we would probably dismantle several industries and create a serious recession.

Our problem is one of trying to recognize the points you make—bend inflation down and keep it bent down—but not at a rate of change that would, for example, dismantle the housing industry. The effects of that would run through the economy. You know, during the last recession we saw housing go from over 2-million starts to 1.1 million starts very quickly.

That was disastrous. Reestablishing that industry to provide the level of housing starts we need has proved very difficult. Maintaining housing at something like an annual rate of 1.8 million starts will involve restraint, but not a precipitous drop.

So timing is the problem we are struggling with; we are doing our best.

In April, we did have problems with the money supply because of the tax payment date which created quite a spike in money for technical reasons. We had to deal with that phenomenon, with those statistics. But it was not representative of credit conditions or the real condition of the economy.

Mr. GRASSLEY. Well, inflation is the biggest contributor to the housing problem we have. Why is it more important to hit the interest rate targets that you want to hit than it is keeping M_1 within its range?

Mr. MILLER. Over the short term, if we tried to keep M_1 within its range, without regard to conditions in the economy, we would have extremely wide fluctuations in interest rates that would be very disruptive. And it would be very hard to see the economy—

Mr. GRASSLEY. What about the long range, if you take the long-range view. You started out by answering my question by saying let us take a short-range view. What about the same question applied long range?

Mr. MILLER. Long range, we definitely want to bring M_1 into its growth range, yes. Money seems to jump up in the first part of the first month of each quarter. I am saying if we worked week to week—and if we should suddenly act in the market to bring M_1 down into our range in any one week—we might have interest

rates at 20-percent. Then the money supply would suddenly be restrained, and the next week we might have 5-percent interest rates. It is much better to average actions over several months—and even then we have been outside the ranges, there is no question of that.

What I am saying is that we have to keep restraint on to bring the rate of growth in the aggregates back down within the ranges. Our hope, in setting the ranges for the next four quarters, is that we are going to be more likely to do that over the next few quarters than we have been in the last few. We are not, of course, sure of that.

Mr. GRASSLEY. Well, when will the long range come?

Mr. MILLER. It came in the first quarter of this year, and it was marvelous. Nobody sent me a letter saying you are within the ranges, but we were.

So, the long run came in the first quarter of this year, when the economy was operating at zero growth. Therein lies the problem: we can get the money growth within its range if you want zero growth. That is the problem exactly.

When inflation is bubbling up far more than anybody projected—including the FOMC, when it set those ranges—you must ask yourself, Will we elect to have an immediate recession in order to bring the aggregates down to their ranges? I don't think that is a good choice.

We are going to have to slow the rate of growth of the money supply, there is no question of that. I hope the long term comes again the next time I am before this committee, so I will be in a more comfortable position.

Mr. GRASSLEY. Thank you, Mr. Chairman.

The CHAIRMAN. If the chairman may interject, your present position is one that I find at least mildly pleasing and reminiscent of an older sergeant I once had who said, "Do like I do, not like I say."

As long as you keep your actual growth rates a little above unrealistic projected rates, the Republic may survive.

Mr. Lundine?

Mr. LUNDINE. Mr. Chairman, on page 3 of your testimony you made a very incisive analysis of a part of the wage-price spiral problem, the increasing advance in unit labor costs. In answer to a previous question, you alluded to the fact that you felt that there was a need to enter into a tougher phase of administration activity on wages and prices.

Do you think that establishing guidelines in basic industries, not controls, specifically stated that it would not be controls, but some guideline which would take into account the consumer, or perhaps any price index, and decrease it for productivity, if there is a productivity advance, and then set a target of maybe reducing that previous level of experience by, say, 25 percent, and then analyzing it industry by industry, and establishing that guideline, would be useful in trying to break this kind of inflationary spiral that we are now in?

Mr. MILLER. Congressman Lundine, I think it might be useful to move somewhat in that direction.

My thought, however, is that rather than government-imposed guidelines—which I think do raise the fear of a process leading to controls—we might establish a voluntary program with a council for each basic industry, that includes industry people, and ask them to submit their own guidelines to be considered.

Sometimes self-set goals can be more valuable than Government imposed goals. It would be worth the exercise to get each industry committed to what it believes itself to be reasonable guidelines that will contribute to deceleration.

Mr. LUNDINE. One of the problems, though, that everyone is—I think it is Arthur Okum that analyzed it to everybody watching a parade standing on their tiptoes. It is a little bit hard to tell the auto industry, now, you restrain your price increase, if we don't know there is going to be something similar done in steel, for example.

Mr. MILLER. Fortunately, the automobile industry has indicated it would abide by the President's deceleration program. But you are right, the goal may be illusory if not everyone imposes guidelines.

But if we took steel, if we took nonferrous materials, if we took autos, if we took other basic industries, and Government and industry participants tried to hammer out, in private, some deceleration guidelines, that might be a good process.

The exchange and debate would itself be useful.

Mr. LUNDINE. Yes, it would.

If we—that is, the Congress and the administration—follow the kind of fiscal policies that you have suggested basically—I mean, perhaps we cannot include every tax idea you have because unfortunately we might be operating under a closed rule, we wouldn't be able to get at it—of course, that doesn't bother Senator Long and his colleagues on the other side—but will you do everything possible, if we follow on those fiscal policies that you recommended, will you do everything possible to bring about your prediction, as I understood the question, that you believe interest rates have peaked and at least for the present time?

Mr. MILLER. I said yesterday that I believe the interest rates will peak between now and the end of the year, and that next year we could see a reduction in interest rate pressures.

I continue to believe that, and I will do everything possible on the monetary side, with my one vote and my chairmanship, to see that we are consistent—that we do not ask for discipline on the fiscal side and then having gotten it, ignore it and become uncooperative.

We get no joy out of being the game in town that is thought to be the cause of high interest rates. Even if we are not the cause, it is easy for people to blame it on the Federal Reserve.

So we would be very delighted to see a condition of less Government demand for credit that would allow us to handle our monetary affairs with more comfort and less pressure—a condition where interest rates top out and slope downward.

Mr. LUNDINE. What I seek is sort of a more restrained fiscal policy combined with what I would call a proinvestment monetary policy. Are you saying that that is an objective that you would—

Mr. MILLER. I think that is a good objective, yes. I can add little to that. Proinvestment policy—accelerated depreciation—should pertain on the fiscal side, too, along with greater spending discipline.

The CHAIRMAN. Mr. Cavanaugh?

Mr. CAVANAUGH. Thank you, Mr. Chairman.

Mr. Chairman, I must admit to being totally confused and frustrated by the M_1 discussion here today. Last April, when you appeared before us, you stated, and I quote:

My purpose is to tell you that the ranges for the aggregates have been established by the FOMC and that we will work extremely hard to see that we live within those ranges, and if we cannot live within those ranges, we will come back and give you new ranges so that you know where we are going.

You didn't live within those ranges. You have come here today and you have given us the same ranges. Your discussion with Mr. Grassley is unbelievable to me. You stated to Mr. Grassley that you can get the money growth within the ranges if we want zero growth.

Now, when you came here in April, I did not understand those ranges to relate to an anticipation of zero growth. Did you at that time—and do you at this time—anticipate that the result of staying within the set ranges will result in zero growth?

In short, if you couldn't meet the ranges in the past, and you promised that if you could not you would set new and more realistic ranges, why are you setting the same ranges here again today, almost with a preconfession that you won't meet them.

Mr. MILLER. Mr. Cavanaugh, I hope I have not misstated myself. In my exchange a moment ago with Mr. Grassley I did not mean to imply that we cannot live within these ranges, nor that, when we presented ranges to you, we did not intend to live within them.

You quote me accurately, however, I did say that if we could not live within the ranges we would give you new ones.

We have given you ranges for a new time period, second quarter 1978 to second quarter 1979. They happen to be the same as those for first quarter 1978 to first quarter 1979.

Under conditions that are likely to exist for the next four quarters, we believe we can stay within these ranges—prospectively.

I did mention that we would probably be in the upper range on M_1 .

I would also say, Mr. Cavanaugh, that we gave you three ranges and that we lived within two of them. Our scorecard is bad; it is imperfect. But, we did live within two of the three ranges for the aggregates.

M_1 has been difficult, as I have pointed out. Obviously——

Mr. CAVANAUGH. I appreciate the difficulty. I think that all that I am inquiring into here is the reality. Clearly, if the range is not realistic for realistic growth aspirations, then you should change the range.

At what point, might I ask you, in the last quarter did you determine, as you stated to us, that to get within the range would have resulted in zero growth?

Mr. MILLER. If you look at chart 8, you will see——

Mr. CAVANAUGH. You understand my question?

Mr. MILLER. Oh, yes.

Mr. CAVANAUGH. When you presented the last range to us—

Mr. MILLER. We are not assuming that we need to go zero growth to be in the ranges. We have not plotted the ranges for second quarter 1978 to second quarter 1979. But looking at actual M_1 the top line—and projecting ahead for four quarters, we are saying that we think we can within the upper limits of the range for M_1 .

When I was here earlier, I pointed out that during the first quarter of this year M_1 was staying within the range. It jumped out during the second quarter of high nominal growth—because of the snap-back of activity from the first quarter and the increased buying by consumers in anticipation of inflation.

I did not predict nor expect the level of inflation-related home or car buying in the second quarter.

So you can see that M_1 was doing quite well until April, but it jumped out in the second quarter. If we can turn it back down—get it back within its range—I think we will have done a creditable job.

The chart shows M_1 above its range for all of 1977. But that has not been true in 1978; in 1978, M_1 has been erratic, jumping around. We want to get it back into the range that we can live with.

We need to look at the data, but not get too committed to what's happening over a 1-month or 2-month period. When we saw the jump in M_1 we did take action, and many people are complaining about that action; many people are saying we are exercising too much restraint.

I suppose you are saying we should exercise even more restraint. But we have to be careful because of what that could do to the economy.

Mr. CAVANAUGH. Well, Mr. Chairman, my time has expired. But I am not saying either of those things. I am simply beseeching you to do what you have told us you would do in April, to be realistic, and to present us with ranges that you are truly going to pursue.

I simply do not feel that you have pursued the ranges that you set for M_1 growth in the last quarter, and I am skeptical that you will be pursuing those that you set for the next quarter because they don't appear to be realistic in the context of everything else that you have presented us.

My time has expired. I thank you.

Mr. MILLER. Let me just say that I agree with you: We should give you ranges that are realistic and we should strive to live within them. That is what we have been trying to do. We have been in the M_1 range part of the time. We have been in the range for the other two aggregates all of the time. But we will try to do better.

[The following are written questions for Chairman Miller submitted by Representative John Cavanaugh, with attached responses:]

Question 1. Mr. Chairman, measured from four quarters ago, M_1 growth has exceed the top of the Federal Reserve's target range from the third quarter of 1977, that is a year ago, until now. Clearly, you (your predecessor) and your colleagues have failed to hit the targets you yourselves set for this critical aggregate for the four quarters ending in the third and fourth quarters of 1977 and the first and second quarters of this year. Yet neither you nor your predecessor have ever advised the Congress that you could not live within the growth ranges which you set for M_1 for those periods. You never announced revisions of the M_1 ranges although

the Fed did abandon the set ranges for M_1 at some point. As a result, economic decisionmakers in industry, agriculture, labor, government and all parts of the consumer and financial sectors of our economy have been laboring with misinformation about Federal Reserve policy from sometime before the third quarter of 1977 until now. This is an unhealthy situation and I hope that in the future you will make sure that it doesn't occur. When you report to us on the conduct of monetary policy, you must not only tell us what your new targets are for the four quarters immediately upcoming, but you also must tell us whether you are going to live within the target ranges you set for the periods ending three quarters, two quarters and one quarter from now, and if not, why not, and what ranges you now plan for these periods. For example, last March and April you should have told us that you couldn't live within the M_1 target range that had been set for the period ending the second quarter of 1978, and why, and set a new target for this period.

I would appreciate your comments on this. Also, specifically, I would like to know whether you are going to live within previously announced target ranges for the four quarters ending this quarter, next quarter and the quarter next after that, and if not why not, and what you revised targets are.

Answer to question 1. The longer run growth ranges for the monetary aggregates are reexamined quarterly by the FOMC in light of recent and expected economic developments. The announced ranges for M_1 were, in fact, revised on four occasions since their inception in 1975 and were kept unchanged on the other occasions.

At the time each set of ranges was announced, it was emphasized that—consistent with the provision of section 2A of the Federal Reserve Act—the FOMC would not feel constrained to keep growth of the monetary aggregates within the announced ranges if economic conditions were to evolve differently than anticipated, warranting higher or lower monetary expansion. This caveat has been particularly applicable to M_1 because the public's demand for this aggregate became quite difficult to predict after late 1974, when M_1 demand began to fall below expectations based on its post-war relationship with income and interest rates. In contrast, from early 1977 to the present the public's demand for M_1 grew faster than the experience in the previous two years would have suggested.

As indicated in the testimony, M_1 growth probably cannot be brought back within the ranges previously set; it is not the FOMC's intention to lower M_1 growth sharply over the near term to make up past so-called overshoots and thereby risk economic disruption. Instead, the FOMC has selected an M_1 growth range for four quarters ahead that at present appears consistent with moderate expansion of economic activity while containing further inflationary pressures—recognizing that in view of recent strength of monetary demand relative to GNP, growth in M_1 around the upper limit of the 4 to 6½ percent long-run range might be expected. However, this projection is subject to great uncertainty, in part arising from the difficulty in anticipating the effects on the demand for M_1 of the authority granted to banks, effective November 1, to permit automatic transfer from savings accounts to demand deposits.

Question 2. Referring to long run M_1 growth, you told Mr. Grassley that in the first quarter of this year, "Nobody sent me a letter saying you are within the ranges, but we were." I know that M_1 grew only 5.6 percent per year in the first quarter of 1978 (measured from the fourth quarter of 1977) but surely, by itself, that did not put you within your M_1 target range in any long run sense. Put otherwise, I know that the achievement of 5.6 percent per year growth in the first quarter of this year put you within the target range for the first of the four quarters ending the fourth quarter of 1978. My question is were you also, at the end of the first quarter of 1978, and taking into account your achievement that quarter, within the target ranges set earlier for the four quarters ending the first, second and third quarters of 1978?

Answer to question 2. The M_1 growth specified in the last four of the FOMC's ranges is compared with actual M_1 growth from the base quarter of each of these four ranges to the first quarter of 1978 in the attached table. M_1 growth was somewhat above the upper end of the FOMC's ranges for 1977 QI to 1978 QI and 1977 QII to 1978 QII but was closer to the more recently adopted range. M_1 growth was right at the upper end of the range for 1977 QIII to 1978 QIII and, as indicated, M_1 growth during 1978 QI was near the midpoint of the range with a 1977 QIV base. During all of these periods, growth of the broader money stock measures— M_2 and M_3 —were well within the growth ranges adopted by the FOMC for these aggregates.

MONEY STOCK GROWTH RATE RANGES ADOPTED BY THE FOMC AND ACTUAL MONEY STOCK GROWTH

[Percent annual rate]

	M-1	M-2	M-3
Adopted range: 1977 Q1 to 1978 Q1	4½-6½	7-9½	8½-11
Actual growth: 1977 Q1 to 1978 Q1	7.5	8.8	10.5
Adopted range: 1977 QII to 1978 QII	4-6½	7-9½	8½-11
Actual growth: 1977 QII to 1978 QII	7.2	8.5	10.4
Adopted range: 1977 QIII to 1978 QIII	4-6½	6½-9	8-10½
Actual growth: 1977 QIII to 1978 QIII	6.6	7.6	9.3
Adopted range: 1977 QIV to 1978 QIV	4-6½	6½-9	7½-10
Actual growth: 1977 QIV to 1978 QI	5.6	6.9	7.7

Question 3. In your testimony, commenting on the questions which Mr. Grassley raised about M_1 having grown faster than the upper limit of the stated growth ranges, you said: "We can get the money within the ranges if you want zero growth, and that is exactly the problem." What range were you referring to? I presume you meant the range set for the four quarters ending in the spring quarter. (If not, what range did you have reference to?)

(a) At what point in the spring quarter was it determined that to get within the set range would have resulted in zero economic growth?

(b) How was it determined that keeping M_1 growth in the stated range would result in zero economic growth?

(c) Following the determination that keeping M_1 growth in the stated range would result in zero economic growth, what action was taken? (i) Was a new M_1 growth range set? (ii) If no new growth range was set, what policies were adopted to assure that the previously set ranges for M_1 would be exceeded?

(d) How did the policies that were pursued to assure that you would exceed the stated M_1 growth range affect your interest rate decisions? (i) Did those policies change interest rates? If so, how? (ii) Have recent interest rate changes affected your decisions regarding M_1 growth? In what way?

(e) Did you anticipate in April, when you last testified before us, that getting within the stated range for M_1 growth would result in zero economic growth? (i) Do you anticipate now that, over the next 3, 6, and 9 months, staying within the M_1 growth range which you just set for the period ending next winter will result in zero economic growth?

(f) What economic growth rate is your current monetary growth target designed to achieve?

Answer to question 3. The reference to zero economic growth was merely an example, based in part on the experience in the first quarter of this year, of the drastic slowdown in real economic activity that could be associated with a precipitate lowering of the rate of M_1 growth simply to conform to a previously established range.

Since the early spring, the Federal Reserve has moved promptly and forcefully to restrain the growth of the monetary aggregates, as indicated by the increase of the Federal funds rate by more than one percentage point from mid-April to early August. These actions—which were partly responsible for the slowdown in M_1 growth over the past three months—were designed to bring average M_1 growth over the subsequent year within the prevailing longer run range.

Testimony before the Committee in April indicated that a growth range for M_1 of 4½ to 6 percent was considered by the FOMC to be consistent with moderate growth in real GNP over the year ahead. Nevertheless, the expected rebound in real economic activity in the second quarter, following the weather- and strike-depressed first quarter, caused a temporary bulge in money growth. Because the FOMC does not view the longer-run ranges as targets to be adhered to month-by-month or quarter-by-quarter, this outcome was not inconsistent with the objectives announced in April.

The current ranges for the monetary aggregates are believed consistent with real GNP growth in the range of 3¼ to 3¾ percent over the coming four quarters.

Question 4. Why do you present us with a target range for which you state, at best, you will be in the top end after four quarters? Why not give us a range in which, as you now perceive the future, you will be able to stay around the middle? Will an effort be made to achieve M_1 growth at a rate below 5 percent in the next three quarters?

Answer to question 4. At the July FOMC meeting, the Committee concluded that keeping the longer run range of M_1 at 4 to 6½ percent was desirable as a reflection

of its commitment to restraining inflationary pressures, while sustaining economic expansion.

It is expected that the implementation of this policy may require resisting what could be continued stronger demands for money relative to GNP than in the 1974-76 period. Given the underlying strength of money demand, it is possible that growth in M_1 over the year ahead will be around the upper limit of the announced range.

Question 5. You said that "until April, M_1 was running within the ranges." Did you mean April 1977 or April 1978? According to figures I have seen, M_1 has been growing outside the announced target range since the second quarter of 1977. However, I thought that your explanation to me about economic activity in April and the second quarter referred to 1978. Could you please explain?

Answer to question 5. In February 1978, the FOMC adopted new longer-run ranges for the monetary aggregates; the M_1 range was 4 to 6½ percent from the fourth quarter of 1977 to the fourth quarter of 1978. For the first quarter of 1978, growth of this narrow aggregate was within the 4 to 6½ percent range. But in April 1978, M_1 growth surged to a 19 percent annual rate, due in part to technical factors associated with larger than usual tax payments and delays in processing of payments around the income tax date, but also because of the rapid rebound in economic activity from the winter levels that had been depressed by bad weather and strikes. (For details of the performance of M_1 , as well as the broader aggregates, for longer periods, see question 2.)

Question 6. You told me that M_1 "jumped out when there was this very high nominal growth in the second quarter because of the push forward of activity from the first quarter." Don't you have the power to prevent M_1 from "jumping out"? If you had emphasized controlling the money supply instead of interest rates, couldn't you have prevented M_1 from "jumping out"?

Answer to question 6. Over a relatively short period, such as a month or a quarter, the Federal Reserve cannot precisely control the rate of growth of the money stock. Nor would it be desirable to do so since varying flows within the payments mechanism frequently cause transitory, self-reversing movements in M_1 . No useful purpose would be served in attempting to prevent such short run monetary accommodations to volatile transactions needs. In addition, even if money growth could be stabilized on a month-to-month or even quarter-to-quarter basis, one consequence would be unprecedented variability in interest rates. For example, the Federal Reserve did take action in the second quarter to restrain money growth when it appeared that M_1 was growing rapidly, and money growth moderated after the early spring bulge. However, additional restraint at that time would have pushed interest rates much higher and run the risk of seriously disrupting the economy.

Question 7. You described M_1 growth to me as erratic. Isn't that because you use the Federal funds rate as your target, allowing money growth to accommodate itself to your attempts to fix the level of that interest rate?

Answer to question 7. Over short periods, such as a month, transactions demands for M_1 change randomly with variations in payments flows. Although the FOMC adjusts its funds rate objective in response to sustained departures of money demand from its projected path, transitory movements in the demand for money are accommodated with the Federal Reserve's use of a Federal funds rate operating guide, thereby allowing short-term variability in the money stock. However, the present procedures insure that variability in the multiplier relationship between reserves and M_1 is largely absorbed by offsetting changes in reserves rather than M_1 . Such variability in the multiplier arises from, among other factors, changing bank demands for excess reserves and shifts, of deposits between banks with different marginal required reserve ratios. With reserves given, these changes tend to alter the funds rate, and open market operations are typically undertaken to resist this tendency—changing reserves. These potential sources of variability in M_1 would not be offset if the Federal Reserve were alternatively to emphasize a reserve aggregate as an operating target. Moreover, interest rates would evidence unprecedented volatility, frequently unrelated to shifts in the underlying demand for transactions balances.

Question 8. You indicated in your response to Mr. Grassley that controlling money supply would increase interest rate fluctuations. Is this true for periods longer than 3 months, 6 months, 1 year, 2 years, 3 years? Is it true for long rates or just short rates? Is the economy more sensitive to fluctuations in interest rates than to fluctuations in money supply growth? Would you provide the statistical and econometric evidence on these questions for inclusion in the record (or, if too voluminous, for the committee's files)?

Answer to question 8. Attempts to control the money stock so as to maintain a predetermined growth rate would certainly increase interest rate fluctuations, particularly short-term rates, over a three month or shorter time span. The effects on interest rate variability over longer periods are uncertain and would depend upon whether the money growth rate targeted is adjusted appropriately to changes in economic conditions. If money demand shifts relative to GNP, maintaining a fixed money growth rate would generate larger movements in interest rates and economic activity over long periods than would an appropriately flexible one. Since the appropriate money growth rate is difficult to predict in advance, some accommodation to emerging pressures may be warranted, resulting in smoother interest rate movements than otherwise. However, too much accommodation to swings in demands for transaction balances stemming from movements in economic activity, as might result from stabilizing interest rates over the intermediate run, could exacerbate the business cycle, causing wider swings in credit demands and both short- and long-term interest rates over the longer run. Thus, whether the economy is more sensitive to interest rate rather than money supply fluctuations depends on whether the economy itself is generating disturbances based on behavioral changes in the market for money and liquid assets or in the market for goods and services. This can be judged only by continuing analysis of emerging financial and economic conditions.

Question 9. You implied in your testimony that you couldn't be "more restraining in money growth because you have to be careful what that does to the economy." In fact, isn't the excessive money growth the Fed has allowed for the last 18 months hurting the economy, resulting in higher interest rates via its inflationary impact?

Answer to question 9. The economic recovery has proceeded satisfactorily over the last 18 months, but M_1 growth has run above the ranges set for it by the FOMC. The satisfactory expansion of the economy developed in part because the FOMC did not actually attempt to press M_1 growth back into its previously set ranges. There is considerable uncertainty, as is well known, in projecting the demand for M_1 relative to nominal GNP. In the past year and a half, the rapid M_1 growth—as well as the rise in interest rates—was partly caused by an unanticipated rebound in the demand for transactions balances relative to GNP, as the earlier pace of innovations in cash management apparently slowed. The broader aggregates, on the other hand, have not been so susceptible to the vagaries of changes in cash management practices, and growth of M_2 and M_3 have remained within their respective ranges during this period.

If the growth in M_1 had been sharply curtailed so as to remain within the longer run range—even though M_2 and M_3 growth were within their respective ranges—short-term interest rates would have risen sharply, economic growth would have slowed, and the risk of recession would have increased significantly. Eventually, interest rates might have declined as credit demands slackened, and long-term rates might have been influenced in addition by a reduction of inflationary expectations. But the cost under such circumstances of a reduction of inflationary pressures would, of course, have been higher employment and reduced output of goods and services. A gradual reduction in M_1 growth back toward the longer-run ranges has the best chance of reducing inflation while sustaining economic growth.

Question 10. Do you think that the speed up in the level of home building and car buying in the second quarter that you described to me was forward-looking (fearing worse future inflation) or backward-looking (making up for less buying earlier, especially in the first quarter)?

Answer to question 10. Some of the strength in housing activity in the second quarter can be characterized as "backward looking." The unusually bad weather of the first quarter was mainly responsible for a more than 50 percent decline in housing starts, and a rebound was expected. Over-all, home building activity appears to be holding up quite well, given the tightening in mortgage markets, but the single family sector is beginning to show some signs of weakness. The level of starts in the second quarter is still off somewhat from the fourth quarter, and the latest indications of new and existing home sales are considerably below their peaks of late last year.

Auto sales were at near-historical levels in the second quarter because many consumers apparently decided to acquire a car before further price increases. The Michigan Survey Research Center has reported record "buy in advance" of further price increase rationales among survey respondents. However, this type of behavior is self-limiting, and a slower sales pace—more in line with income growth and replacement demand—is expected in the near future, possibly showing up with the introduction of the more expensive 1979 models in early October.

The CHAIRMAN. Mr. Leach?

Mr. LEACH. Chairman Miller, I don't want to belabor an issue that you have talked about here. However, I am somewhat perplexed by your attitude on capital gains. As I understand it, your view is that you support the principle of the capital gains cut but question its timing.

The problem I have is that the only realistic reason for you to be concerned is the revenue loss to the Treasury.

Other than the administration, most independent economists are quite firm that revenue losses to the Treasury would be negligible with, for example, the Steiger capital gains tax cut.

Can't you say something a little more sympathetic toward capital gains? It is going to be a spectacularly important issue this year. Can't you be more forthcoming?

Mr. MILLER. Let me elaborate a little, if I may, Congressman Leach.

I want to be careful not to misstate myself in either direction—opposed or in favor. It is the timing of the Steiger, Jones, and other proposals that concerns me; I have for some months now been concentrating on the need to reduce the Federal deficit for fiscal year 1979.

I felt that we needed to move down to the level of deficit that is now shaping up. I felt that this was such a high priority that any effort to impede it—any doors left open that might change the prospect—were undesirable.

Now that we are thinking about a \$43.5 billion deficit, instead of a \$60.5 billion one, now that we are thinking in terms of a \$15 billion-plus tax cut instead of \$25 billion, we know we have only so much to allocate. So we have to ask what will be the best way to use that money.

Whether or not the Steiger amendment would, after x years, break even in revenues is not the issue. The issue is what would it do to the budget that we are now trying to squeeze down.

I understood there was a general consensus that it would produce a \$2 billion or so revenue loss in the first year—

Mr. LEACH. That consensus exists only in the Treasury Department, certainly not outside it.

Mr. MILLER. Then I may be misinformed. But information from independent sources shows a cost in the first year. If we look at the effects of inflation on income tax brackets and on real income of individuals, we see the need for relief. If we look at business investment, we see the need for more direct stimulation. I think those are the priorities; relief in the capital gains taxes is secondary. The linkage to capital investment is too weak.

I also have said that as we progress on a course that will balance the budget with full employment in 1982, and as we progress on a course to reduce Federal spending from over 22 percent of GNP to 20 percent, then it will be timely to look at capital formation and taxation. It is too early to endorse one proposal over another. I don't know whether relief of double taxation or dividends, or relief from capital gains taxes—or the Jones or Steiger view of such relief—would be best.

This position shows my determination to be consistent in setting priorities.

If there is x billion dollars to use in making tax reductions, I feel it should be used more directly—more directly linked up with actions that will reduce inflation, both short- and long term—rather than used in indirect actions that will have to work their way through and that do not assure an early enough impact on solving our problem.

It is not that there is a philosophical break with these proposals. It is just if there is only so much money to hand out in the family, we have to establish allowances.

Mr. LEACH. My time has expired. I am sure you would just as soon move to another subject, anyway.

Mr. MILLER. Not at all. It is a very happy subject. Cutting taxes is always a fine subject.

The CHAIRMAN. Ms. Oakar?

Ms. OAKAR. Thank you, Mr. Chairman.

Chairman Miller, as a followup to a question that I asked you yesterday, I would like to just recap for you.

Yesterday you proposed a plan for making membership in the Federal Reserve Board attractive and we were talking about deficits almost all morning. As you know, this plan would add at least \$300 million a year, I believe; your plan, that is.

How would these additional expenditures be best financed so as to do the least harm to the economy? Through an increase in taxes, borrowing from the public or by issuing more money?

Mr. MILLER. I am afraid, Congresswoman Oakar, that there is a misunderstanding; the membership plan would not cost the Treasury any money.

Ms. OAKAR. OK.

Mr. MILLER. The point is that if the plan were in effect today—fully in effect—there would be a net reduction to the Treasury of \$300 million. But if the plan doesn't go into effect, there is going to be a \$300-million loss to the Treasury in 4 years anyway.

By phasing our plan in—so as not to affect revenues in fiscal year 1979, to have some effect the next year, and some the year after—as we offset what otherwise would be a loss of membership and a loss in revenue. We view it as a proposal of zero cost to the Treasury.

If we don't solve the membership problem, the Treasury will have \$220 million less in 1981, than we are able to return to it this year.

Ms. OAKAR. But your plan initially would have a cost factor.

Mr. MILLER. Not this year. It phases in very slowly. It starts by charging for services and paying very low rates of interest. It doesn't become fully effective until 1982.

You will find the Treasury Department supportive of our view that we are trying to stem revenue losses.

However, there will be an actual payout, and we certainly realize that the Treasury cannot measure exactly the loss of revenues in the absence of this program. But from their point of view it looks like the program will result in less loss.

Ms. OAKAR. That is right.

Mr. MILLER. To solve the problem of revenue loss we have agreed to pay to the Treasury \$575 million from our surplus over 3 years.

This will cushion the short term effect until, in the longer term—as I mentioned—any costs wash out.

So there is no need to finance this plan in the ways you suggest. The money will go from the Federal Reserve to the Treasury. There is no need for taxes to be raised; no loss. By 1982, by stopping the loss of membership, we will be at a break-point.

Ms. OAKAR. So, realistically that is what would happen, right?

Mr. MILLER. We are not going to guess about it in the first 3 years; we are going to pay money to the Treasury so that they actually receive \$575 million from the Federal Reserve.

Ms. OAKAR. I do want to ask you to comment on one other factor. One of the least talked about expenses and costs has to do with unemployment compensation. I have been appointed to the National Unemployment Compensation Commission.

We have been doing a lot of research on this. It has really been interesting to me to see that last year, for example, we paid out almost \$20 billion in unemployment compensation checks.

This has been increasing yearly since the inception of the program in the late thirties.

I am wondering, can you think of a better way to stimulate employment or use of that money or do you have any thoughts on that as a factor in inflation? It is never mentioned. You mentioned social security taxes, and so forth, but this factor is very seldom mentioned.

Mr. MILLER. The cost of unemployment compensation did go up at the beginning of this year, which added to inflation. There is no new increase planned for January 1, as I understand it, but you have raised a good point. There is something about the way unemployment compensation works in the economy that needs reform.

One possibility would be to tax unemployment benefits. Many families with relatively high income receive unemployment benefits. I think the President has a proposal to phase a tax in. That would be a good move because we are all aware of a good deal of "optional" unemployment among families who have investment or other income.

It seems to me that the purpose of unemployment insurance should be to cushion the effect of unemployment on those who have no other resources; that is a good social purpose. But it shouldn't work so that if a person decides to go on a sabbatical that person can draw a check from the Government.

That is a poor use of money. That is where reform needs to come. Relief for those unemployed who have no other financial resources is an important social objective.

Nor is it inconsistent to supplement unemployment insurance with targeted programs that provide better training and better preparation for existing jobs or for new jobs in a changing economy that require new skills.

Ms. OAKAR. Chairman Miller, you did make some comments about unemployment. Your predecessor always used to include women in terms of it, and I would get into it with him about how women were entering the job market in increasing rates.

I am wondering if you care to comment on that because you really didn't mention the problem of unemployment as it affects

women who happen also in many cases to be the heads of household.

Mr. MILLER. We know that unemployment among heads of households is down to 3.6 percent.

I think the change in the role of women in our society has been a very healthy thing. It has resulted in their seeking career opportunities on an increased and on a more fully equal basis. That is healthy but it means a period of transition during which the composition of the labor force changes. There is a one-time adjustment as the women begin to seek equal employment.

We have seen this phenomenon; the new population has been absorbed fairly satisfactorily. One result is that today—even though we have 5.7 percent unemployment, which is too high—we also have the highest percentage of our working age population employed that we have ever had—58.9 percent of our working age population, a very high percentage—

Ms. OAKAR. But you don't have a breakdown?

Mr. MILLER. No, I don't have that breakdown. The participation rate for women is 48 to 49 percent, I think; the employment to population ratio is a few points lower. The process has started, and I hope it will be completed.

Ms. OAKAR. Sure.

Mr. MILLER. The process is going in the right direction. I think the participation rate of women is in the high forties now. The fact that the rate has gone up from the thirties to the high forties is very encouraging; it has been one of the underlying factors in growth of the economy. It will add to the capacity to produce; it will add to the capacity to earn; it will add to the capacity of the economy.

Women's participation in the labor force is an inadequately studied phenomenon; I believe there has been more impact than we realize. But I do believe the trend is right.

Ms. OAKAR. Thank you, Mr. Chairman.

Mr. Chairman, I am sorry my time has expired because my good friend Mrs. Fenwick had a very good question that I would have loved to ask on her behalf. Perhaps she can have the time.

The CHAIRMAN. Either you or Mrs. Fenwick are invited to submit the question to Chairman Miller, and I am sure he will answer it for the record.

Ms. OAKAR. Thank you.

Mrs. FENWICK. Thank you.

[The following correspondence was submitted for the record regarding Representative Fenwick's question and Chairman Miller's response:]

MILLICENT FENWICK
5th District, New Jersey

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August 3, 1978

Mr. G. William Miller
Chairman, Board of Governors
Federal Reserve System
Washington, D.C.

Dear Mr. Chairman,

Thank you for your excellent testimony before the Banking Committee on July 27 and 28. During the question period, after my time had expired, I asked Mrs. Oakar to submit a question for me. The record has been left open for that question, and I would be grateful for your response.

You have recommended accelerated depreciation to encourage investment in new equipment. What is the correlation between this kind of capital investment and employment?

Thank you again for your help.

With all good wishes,

Sincerely,


MILLICENT FENWICK
Member of Congress



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

G. WILLIAM MILLER
CHAIRMAN

August 15, 1978

The Honorable Millicent Fenwick
House of Representatives
Washington, D.C. 20515

Dear Millicent:

Thank you for the opportunity to comment on the relationship between capital investment and employment. I believe that we have invested too little for too long. The consequences of inadequate capital formation have affected the level of employment in several ways. It is widely recognized that investment expenditures, in stimulating the economy, lead to higher levels of employment both through the employment of workers in production of equipment and construction of facilities, and through a consequent general increase in aggregate demand.

The addition of new plant and equipment, along with the modernization and replacement of old capital stock leads to higher labor force productivity. Increased industrial capacity allows higher levels of output to be attained before bottlenecks and shortages generate inflationary pressures. In this manner, timely capital formation can facilitate the achievement of higher sustained levels of employment without increasing inflationary pressures. Also, a more modern, more productive industrial structure would allow the United States to compete more effectively in international markets. The record of West Germany and Japan stands out in this regard. Finally, increased labor productivity and higher sustainable levels of employment would clearly permit a more rapid rise in the Nation's standard of living.

In order to augment the rate of fixed capital formation, it is necessary to increase the willingness of the private business sector to invest in plant and equipment. Of the various approaches toward stimulating business fixed investment, providing for accelerated depreciation seems the most attractive option. Accelerated depreciation can be readily and rapidly implemented within the current tax structure through either adopting shorter service lives or allowing use of faster write-off formulas. Both accelerated depreciation and the investment tax credit provide a direct linkage of tax incentive to investment response. In contrast, reduction of the corporate tax rate, replacement value depreciation or dividend deductibility, provide similar tax benefits to existing capital as to new investment projects. Compared to the investment tax credit, accelerated depreciation has the advantage that tax liability is deferred, rather than forgiven. Thus, a greater impact on capital investment can be accomplished with accelerated depreciation than through the use of these less sharply focused measures.

Again, thank you for requesting my thoughts on this important matter.

Sincerely,

A handwritten signature in dark ink, appearing to read "Bill", written over a light-colored background.

The CHAIRMAN. Congressman Bill Green?

Mr. GREEN. Mr. Chairman, I would like to return to the question of capital gains and pose some arguments that in fact a capital gains tax reduction is a greater stimulant to productivity increases than methods of helping internal generation of capital like accelerated depreciation or the investment tax credit.

I would like to suggest that the accelerated depreciation and the investment tax credit primarily help the larger and frequently the more mature and oligopolistic corporations, the GM's and people like that.

I also suggest that programs that increase the internal generation of capital enable corporate managements to avoid the discipline of having to compete for capital in the capital markets. I think you know as well as I do that there are empire builders in corporate bureaucracies just as much as there are in the Government bureaucracies. At the same time, I would like to suggest that reduction in capital gains taxes will improve the operations of the capital markets, and that it will be particularly helpful to the smaller enterprises looking for venture capital that are dependent on people who are willing to take high risks and who, therefore, have the right to expect high rewards if they are to take those risks.

In fact, many of these smaller businesses are those that are on the cutting edge of new technologies, new business ideas, and breakthroughs which are the most likely to produce very rapid increases in productivity.

As you know, with the very rapid increase in capital gains taxes, that segment of the capital market has all but dried up. It has been very difficult for people in these new businesses, the people involved in the state of the art kind of technologies, to raise funds even when they are successful; very typically these days they are forced to merge rapidly with much larger firms instead of being able to continue to grow themselves.

Wouldn't the capital gains tax, therefore, have a lot of advantages in terms of productivity as compared with internal generation of capital in larger businesses?

Mr. MILLER. Congressman Green, I think you have made some very good points. I would just mention that when you try to achieve that objective—stimulate new business and productivity—by a reduction in capital gains taxes, not all of the money released—not all of the lost revenue to the Treasury—will go to that purpose.

Money will go to buy stock in large corporations; it will go to buy postage stamp collections; and it will go to buy art. Nonetheless, I think your point is a good one, and it is the reason I think we should be willing to look at ways—perhaps more targeted ways—to assist the formation and perpetuation of new and smaller businesses, and particularly to return to the venture capital movement the excitement it once had.

Now if we could find a way for capital gains taxes to be reduced only on stock in new enterprises—for the first owner of such stock or something like that—we might produce more stimulus at less cost. But I am not closing my mind to such suggestions.

What I am really saying is that the economy cannot wait for a few million dollars of venture capital that requires a 7-year question period; I have been in the business and I know there is a 7-year gestation period. We have the immediate problem of getting productivity gains going. To do that, we have to affect the enterprises that are already, collectively, spending billions.

If we could get existing enterprises to put \$10 billion more into investment the effect would be immediate, while if we get \$5 million more or even \$100 million more into venture capital we will have to wait 7 years for much results.

Venture enterprise is important, terribly important, to our vitality and to new technology. But it is important that we put our choices into priority, and I think the first priority is investment and productivity gains. After that, as I say, let us address those other issues—find a way to get the great innovators out of the laboratories to start businesses and build them. They used to do that but they don't now because they can't keep the business going and they won't take the risk; their families are at risk for 5 years until the business is over the hump. I am with you; I would like to see new ventures grow up.

Mr. GREEN. I guess the base difference between us is as to what the actual cost is of capital gains tax reduction.

Mr. MILLER. If you can narrow the costs by keeping within the field of new businesses, I think we would have room at any time.

Mr. GREEN. Thank you.

The CHAIRMAN. Mr. Roussetot?

Mr. ROUSSELOT. Thank you very much, Mr. Chairman.

I apologize I wasn't here earlier, but I have gone through your statement and I am fascinated and appreciate many of the things you stated.

I hope we will pay attention to your statement. I notice on page 5 that you made a similar statement to the Budget Committee. On the bottom of the page,

In financing the Federal budget deficit the Treasury has competed actively with the private sector for credit and has added to the general upward pressure on interest rates.

For some reason we have a hard time getting Congress to understand that this is the result when we vote for these very, very substantial deficits which we do continually for all kinds of excuses. But I hope we can help you on that issue, and that is why I have always offered a balanced budget resolution.

I am having trouble with votes, but I am up to 170, so maybe we will get it some day.

On page 11 you also, I think, state very correctly, that we must reshape our tax laws to make certain that there are adequate incentives for saving and investment. "The Nation has for many years now quoted too large a portion of its production to consumption."

In some cases we overstimulate, and as you have just stated now in answer to Congressman Green, we make it impossible for people to keep some of the earnings for investment or to have the incentive to invest.

You have just stated that you ran into that problem when you were running your own business. Now on the basis of that state-

ment, you proceed to question the timing of the tax cuts approved last night by the Ways and Means Committee, on which I now serve, and suggested that the \$4 billion in relief to homeowners could better be used to provide for accelerated depreciation.

Just to clarify—I know you have partially answered this before. Is it the timing of the whole package that you question, or is it just the timing of the elimination of the capital gains on sales of residences that you question?

Mr. MILLER. Congressman Roussetot, I am questioning the timing without making any judgment on the merits. Again, I repeat—

Mr. ROUSSELOT. On the basis of your statement what do you believe we need to do to reshape our tax laws to make certain there are adequate incentives for saving and investment?

Mr. MILLER. I am sorry; I haven't had a chance to study the details of the tax package. My impression is that relief for the store of value represented in homeownership is a good objective.

Again, I don't know that it has to be done this year, but as I say I haven't seen the details. My guess is that it is a constructive move because homeownership is the one way families have been able to store some wealth, and giving them the chance to use it over the long term is desirable.

But I don't think the housing stock in America will turn over next year, while I think the stimulation of investment should. So I would like to see that kind of relief come later.

Mr. ROUSSELOT. So, it is the timing of its being put in place?

Mr. MILLER. Yes, sir.

Mr. ROUSSELOT. So what would you say, 2 years from now?

Mr. MILLER. I would be willing to look at it as part of next year's program provided we are bringing down Federal spending.

Mr. ROUSSELOT. 1979?

Mr. MILLER. For 1980.

Mr. ROUSSELOT. Or 1980.

Mr. MILLER. What we do now affects 1979; what we do next year will affect 1980.

Mr. ROUSSELOT. Yes. How about the timing of the rest of the package?

Mr. MILLER. The tax cuts to individuals, as far as I can tell without study, are timed right and are probably of the magnitude that we had in mind. I suspect they are closely in line with our expectations. We had expected about two-thirds of the tax cut to go to individuals, and I think this is about what was reported out.

Mr. ROUSSELOT. About \$10 billion, as I recall.

Mr. MILLER. In that neighborhood. I haven't seen the details of the business tax changes yet, so I am not able to comment on those.

Mr. ROUSSELOT. All right. Could you comment on—

Mr. MILLER. I would be happy to submit comments, which probably would be better because I am getting my information from the newspapers now.

[Chairman Miller subsequently submitted the following for inclusion in the record:]

The business tax changes recommended in the House Ways and Means Committee package are estimated to total somewhat less than \$4 billion. The reductions in the corporate tax rates would be effective at the beginning of 1979, just like the cuts in

personal taxes. In addition, there is the recommendation to reduce capital gains taxes by somewhat less than \$2 billion. Without prejudging the merits of the composition of this tax bill, I would consider its overall size and timing to be reasonable.

Mr. ROUSSELOT. I must assure you also that some of the members of the committee are still trying to find out what was done.

Mr. MILLER. Some of those who voted for it, probably.

Mr. ROUSSELOT. And the staff pleaded for extra time to write all of the views on the bill, too, because there were some changes that weren't expected in the Jones-Ullman-Steiger package.

Well, thank you for your time.

The CHAIRMAN. Chairman Miller—

Mr. ROUSSELOT. I guess I have one more question.

You mentioned in the Budget Committee that idealistically you thought cuts may be upped to \$10 billion on the expenditure side; that is, in the increases. Again in the 1979 budget—

Mr. MILLER. That is right.

Mr. ROUSSELOT. We are talking about an increase in expenditures, we are not talking about heavy cutbacks—

Mr. MILLER. That is right.

Mr. ROUSSELOT. Heavy cutbacks in any area. Do you still stand with that?

Mr. MILLER. You had a \$496 billion ceiling, and I said that ideally I would like to see that cut \$10 billion—

Mr. ROUSSELOT. That would be \$486 million?

Mr. MILLER. I said that as a practical matter I thought you could cut to \$490 million; I think that is still true.

Mr. ROUSSELOT. Yes. Idealistically you thought we might even—

Mr. MILLER. Go further.

Mr. ROUSSELOT. Down to \$486 million.

Mr. MILLER. Yes.

Mr. ROUSSELOT. We might scrape out a little further here and there in the budget.

Mr. MILLER. Yes.

Mr. ROUSSELOT. I appreciate it. I am glad—

Mr. MILLER. I think that is still a good plan.

Mr. ROUSSELOT. I do, too, but the problem is to persuade our colleagues, a majority on the Budget Committee.

Mr. MILLER. That is right.

The CHAIRMAN. Chairman Miller, I do want to recognize Mr. Neal briefly for a moment. We are approaching the noon hour. I want to thank you again for giving us two very full mornings, and I want to thank our colleagues for covering the subject matter with you very thoroughly on monetary policy, the subject of this hearing. You have been very forthright.

I simply renew at the morning's end what I said at the beginning, that in my judgment interest rates both at the long and short term are higher than they need to be to combat inflation effectively, in view of the apparent determination of both the administration and Congress, which you generously have recognized, to pursue a fiscally responsible course.

Thus, I think that capital investment which we want, housing which we want, and many other things would be helped by a shift as promptly as possible to a somewhat easier monetary policy.

My other remark is suggested by some of the arithmetic of the various proposals floating around, to prevent erosion of Fed membership and to enable the Federal Reserve to achieve better control of money. Many of us on the committee have, it is fair to say, a slightly different view—

Mr. MILLER. Yes.

The CHAIRMAN. Of the costs, especially those involved with the Fed's estimates which hold that if you give the banks more money and more earnings, Treasury is going to get it back the next day. They don't seem to have adequately taken into account the propensity of banks like the rest of us human beings to build beautiful skyscrapers, to pay higher salaries, and other things which don't result in higher income taxes. Of that more, anon.

You have said just now that the Fed, looking at its billion-dollar-plus reserve, figured out that it could ease the fiscal shock to the economy of giving all the money to the banks in the next year by taking something over half a billion dollars of that and restoring it to the Treasury, and thus lessening the deficit which you are dedicated to doing.

My question is: Isn't something worth doing at all worth doing well? Why don't you be a great hero and take that whole fiscally useless billion dollars—you have admitted, honest man that you are, that you arrived at the \$575 million by figuring backward, and that that would get you off the hook—why not give the taxpayers of this country a real break?

Why not send the dollar soaring on international markets by, with one stroke of the pen reducing our deficit, turning the \$1 billion all over to the Treasury, in whatever easy payments will make your Comptroller's task the most beneficent?

Mr. MILLER. Mr. Chairman, it is worth considering, but I am reminded—as one of the relatively few Chairmen of the Federal Reserve—that its founders insisted upon building a surplus. If I gave it all away in one fell swoop, I am sure there would be a lot of rolling over in graves. I have to think about that.

The CHAIRMAN. For all the rolling in the graves, I will give you millions of happy live ones, if you would help us balance our budget.

Mr. Neal?

Mr. NEAL. Thank you, Mr. Chairman.

Chairman Miller, I would like to pursue the earlier line of questioning. I read yesterday that the latest Commerce figures indicate the economy will grow next year at about 3 percent rather than a little higher rate which was earlier projected.

You were indicating that the money supply probably is going to grow at somewhere around 6 to 8 percent. I am just wondering if you share my view that such a rate of growth in money supply, which is beyond the rate of growth in the economy, is going to have a severe inflationary impact in the next year and the year after.

Mr. MILLER. Congressman Neal, we are dealing with nominal growth. The figures you saw are one estimate; over the next four

quarters, I think my own estimate of $3\frac{1}{4}$ to $3\frac{3}{4}$ percent real growth is more realistic.

But, if you add the $3\frac{1}{2}$ percent of real growth to a $7\frac{1}{2}$ or so percent rate of inflation, you would get $10\frac{1}{2}$ to 11 percent nominal growth in the economy. If we do hold the rate of money growth substantially below that, we will be making some progress—in what will be the fourth and fifth years of expansion—in restraining the forces of inflation.

You are correct: we are not bringing down the rate of money supply growth to its ultimate rate, which would be closer to the real rate of growth in the economy.

All I can say is that the only way I know to achieve that condition—without creating economic dislocation—is to keep starving the inflationary forces and keep moving the growth rates down gradually by one-half or three-quarters percent per year until we finally conquer inflation.

Mr. NEAL. Mr. Chairman, I would agree with you that is the way to do it, but when I look at the figures I don't see us moving in that direction. I know you are under all sorts of pressures. I know our chairman, for instance, would like to see you—

Mr. MILLER. Do more?

Mr. NEAL. Do more. I would like to see you do less.

Mr. MILLER. Monetary policy must be perfect these days: according to my survey, 50 percent of the people think we are too tight and 50 percent think we are too easy, so we must be perfect.

I appreciate your point. We are subject to pressures: Pressure from those who feel that more restraint would bring on economic downturn which would result in higher Federal deficits and a lot of human upset, but not retard inflation; and pressure from those who feel we should expand more because we still have unemployment in the economy; and pressures from those who think additional tightening is required.

Mr. NEAL. I understand that, and I commend you for trying to move in that direction because I think it will mean more employment for the long haul, and lower interest rates for the long haul, a healthier economy for the long haul, and less inflation for the long haul.

You mentioned in answer to an earlier question, the problem with demand-pull inflation. Doesn't monetary policy have a real impact on that?

Mr. MILLER. We are saying the right thing when we say we need better coordination between monetary and fiscal policy. We are also being selfish, because to the extent that there is more discipline in fiscal policy we have a better chance for monetary policy to achieve what you suggest.

Mr. NEAL. I agree with you. We are moving in that direction better than I have seen in several years, as a matter of fact, but it is not the whole story. Monetary policy is also very important.

Mr. Chairman, you say 50 percent are on one side and 50 percent on the other, so you must be right. I would have to guess that one side is wrong.

Mr. MILLER. Fifty percent are wrong.

Mr. NEAL. Fifty percent are wrong somewhere. I think I know which 50 percent it is.

Mr. MILLER. I am impressed that this is a bipartisan issue. I get mixed up in this committee, because monetary policy seems to be a religion above politics.

Mr. NEAL. Well, we have a nice bipartisan effort to reduce the rate of growth.

Mr. MILLER. That is correct.

Mr. NEAL. That is all we are suggesting, some gradual reduction over time. What I ultimately fear is that the economy will keep heating up, the rate of inflation will increase, and then there will be some real pressure on the Fed to cut back drastically, as happened several times in our history. That would be a disaster for our country, I think.

I commend you for a difficult job. There is no more important job in this country for the health of our economy.

I sat here for a couple of years and listened to Dr. Burns talk a very conservative line and then print money at outrageous rates and then cut off the money supply which had a very, very decided effect on creating a recession.

I just don't want to see us go through that cycle again. I think we have the opportunity now to gradually reduce the rate of the money supply, gradually reduce the budget deficit, provide for the healthy economy for a long time to come, and I just hope we won't go through these wild binges again.

To avoid them, I think we are going to have to slow down the growth of the money supply.

Mr. MILLER. Mr. Neal, I just want to say that I understand your philosophy and think it correct. Earlier this year, when I was looking at the economic plan for calendar year 1978, remember the outlook was for a 4¾-percent rate of real growth.

When I first appeared before this committee, I think I had already begun to say that 4 to 4¼ percent made more sense, if we were to accomplish some restraint on inflation.

Now we are looking at growth for this year of 4 percent or less—and a slower growth next year. So we have made some progress in demand-pull inflation, and everyone has been contributing, regardless of his view of monetary policy.

So, while things are not perfect, I do detect far more consensus about the right pressure to put on the controls in order to sustain the growth of the economy, prevent it from falling into recession, and keeping it at a rate of speed that doesn't heat up the forces of inflation.

It is a very difficult task now to judge just how fast to keep the economy going. All I can do is say that we will do our best to act prudently in that regard.

Mr. NEAL. Just one further point, Mr. Chairman. I am not sure I understand correctly what you said. When you said we have slowed the rate of growth in the economy—

Mr. MILLER. As a nation.

Mr. NEAL. Hasn't inflation been the major cause in that slow-down in the economy?

Mr. MILLER. No, I don't think inflation is the only cause. The stimulative forces that were projected to go into the economy have been cut back.

Inflation has been a factor in the second quarter. Strangely enough, as we have been pointing out the danger of inflation, many consumers have been taking on debt regardless of its costs—and buying durables and houses regardless of the interest rate, for fear of future price increases.

So in that sense the short-term consequence of fighting inflation has been a stimulus. But many other stimulating forces have been restrained.

Mr. NEAL. I thank the Chairman, and wish him well in his endeavors.

The CHAIRMAN. I thank the gentleman. Once again, Chairman Miller, thank you for your very outgoing and cooperative presentation. I hope you have a little rest during the month of August.

Mr. MILLER. Thank you very much, Mr. Chairman.

The CHAIRMAN. We will adjourn at this time.

[Whereupon, at 12:05 p.m., the committee adjourned, subject to the call of the Chair.]

[The following "Briefing Materials" was submitted for the record by the Subcommittee on Domestic Monetary Policy:]

BRIEFING MATERIALS
PREPARED FOR THE
QUARTERLY HEARING ON MONETARY POLICY

BY THE

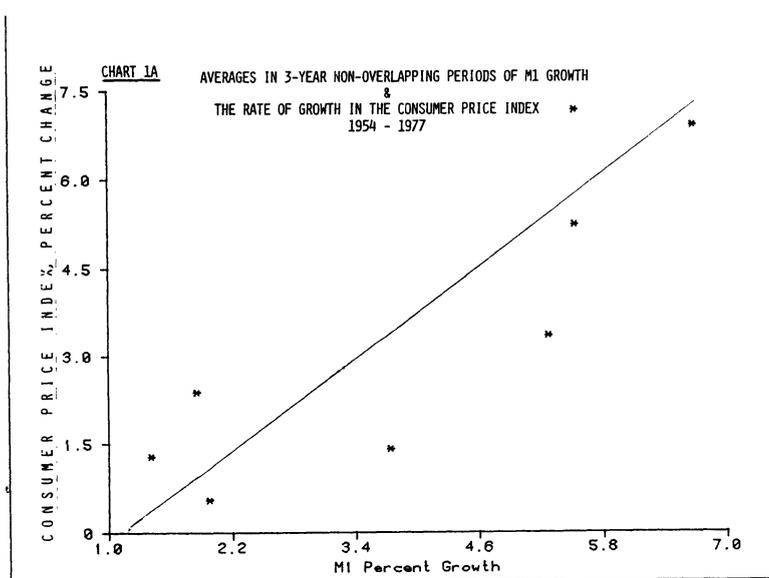
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY

JULY 28, 1978

EXHIBIT 1. Exhibit 1 breaks the 1954-1977 period into eight consecutive 3-year periods: 1954-1956, 1957-1959, etc. For each 3 year period, Chart 1A relates average M1 growth to the average rate of rise in the CPI (inflation); Chart 1B relates average M1 growth to the average rate of interest on 3-month Treasury bills; and Chart 1C relates average M1 growth to the average rate of unemployment.

The exhibit shows that there is a close positive relationship between money growth and inflation (Chart 1A) and between money growth and the rate of interest (Chart 1B). It shows that as money growth increases, so do both inflation and the rate of interest. However, it also shows that there is no relationship between the rate of money growth and the rate of unemployment (Chart 1C). This belies the Phillips Curve theory that inflation is inversely correlated with unemployment.

The closeness of these relationships is denoted by the lines which were fitted in between the points on the graphs. Note the straight lines which were easily drawn in Charts 1A and 1B. It was impossible to fit one line into Chart C.



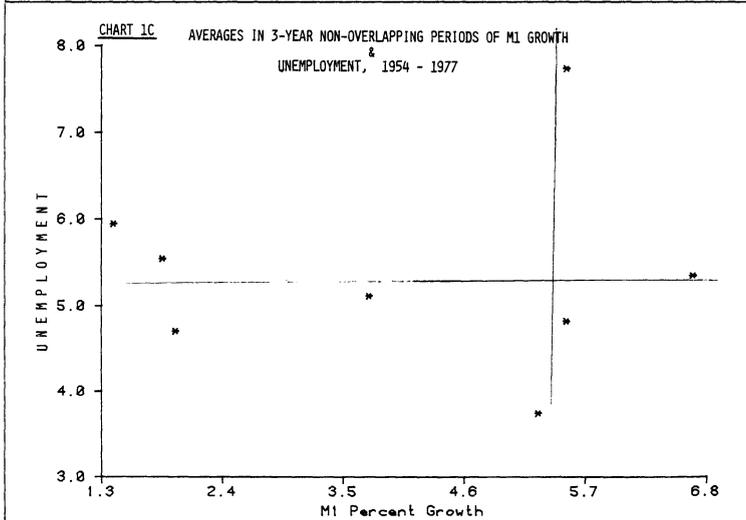
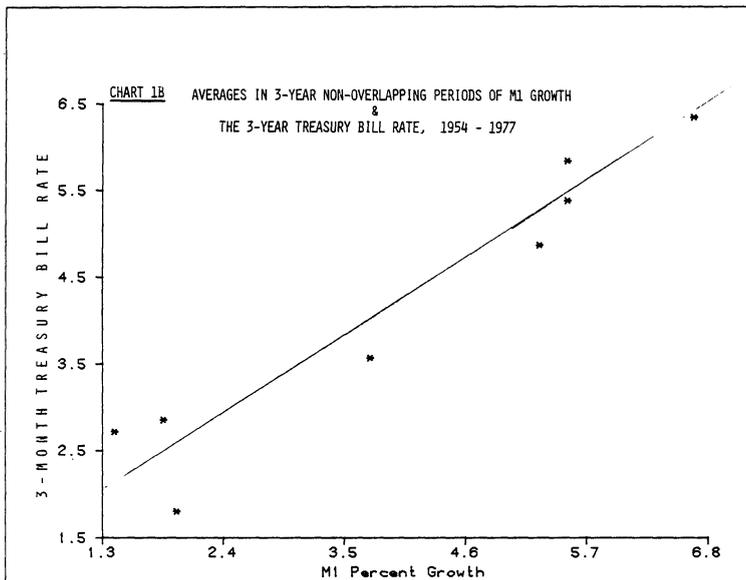


EXHIBIT 2. Exhibit 2 provides another way of looking at the relationships between money growth, inflation and interest rates. Exhibit 2A charts the percentage changes in the CPI against percentage changes in M1 (money supply) which has been lagged two years. The exhibit shows that the rate of inflation closely follows M1 growth two years earlier. The only significant miss occurred in 1974 when the rate of inflation exceeded the 1972 rate of money growth by about 4 percent. That was the year during which OPEC raised the price of oil, which explains the gap. The percent rise in the price of imported oil (weighted by oil imports as a percent of GNP) in 1974 was 4.4 percent.

Exhibit 2B plots the percentage changes in the CPI measured between the same months from one year to the next and the Federal funds rate--the overnight inter-bank interest rate--in the last month. It shows that monthly movements in the Fed funds rate occur very closely together with changes in the inflation rate measured from the same month a year ago. This indicates that even short-term interest rates are very powerfully affected by immediate past inflation.

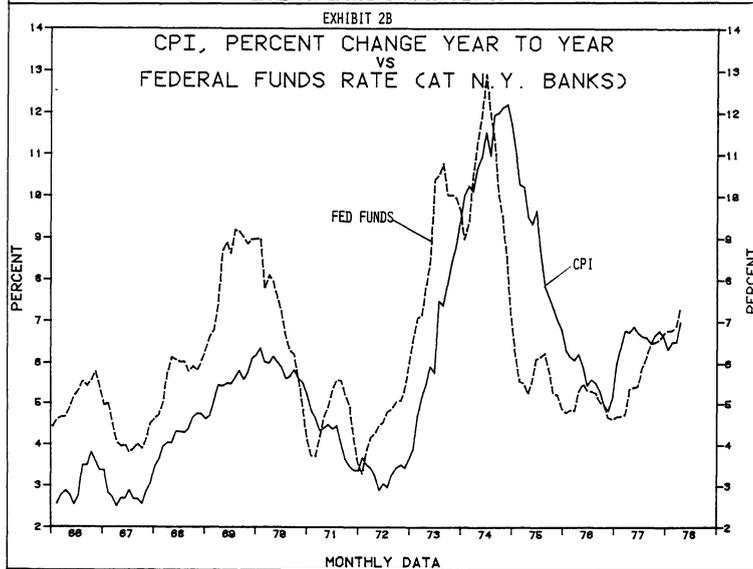
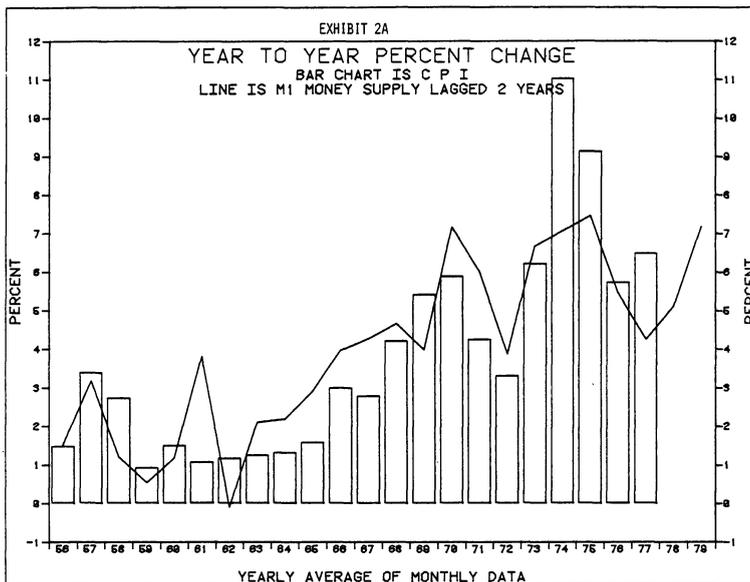


EXHIBIT 3. In March, 1976, one year after the Federal Reserve began announcing M1 target growth ranges, M1 entered the range at the lowest end, and then crawled along the bottom for six months. In October, 1976, M1 was increased to the middle of the range and kept there through March, 1977. In April, 1977, M1 growth hit the top of the target, and in July, 1977, it burst through the top of the range. M1 has now been growing outside the announced target growth range for over a year.

EXHIBIT 3

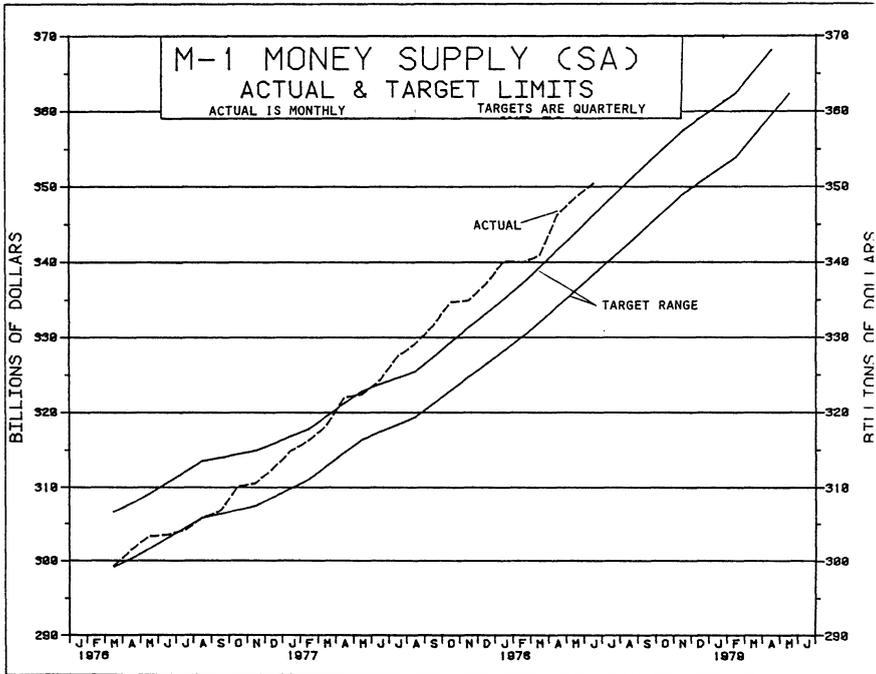


EXHIBIT 4. This graph shows the percentage change from a year ago of three money supply measures, M1, M2, and M3.

M1 is currency plus demand deposits.

M2 is M1 plus time deposits excluding CD's.

M3 is M2 plus nonbank thrift deposits.

Essentially, the growths of the three M's move up and down together. Thus, in measuring the thrust of monetary policy, it does not matter very much which of the M's is monitored.

EXHIBIT 4

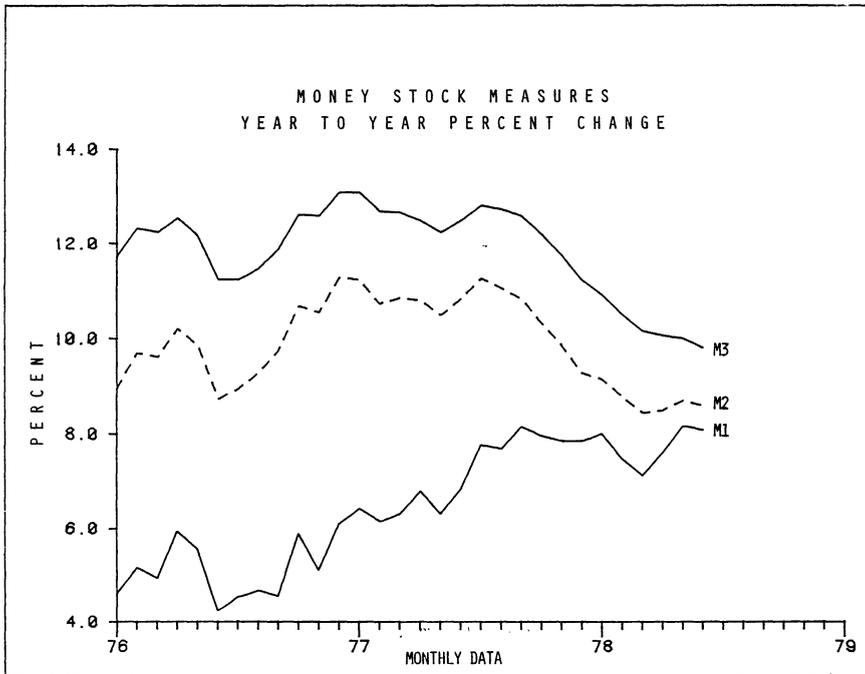
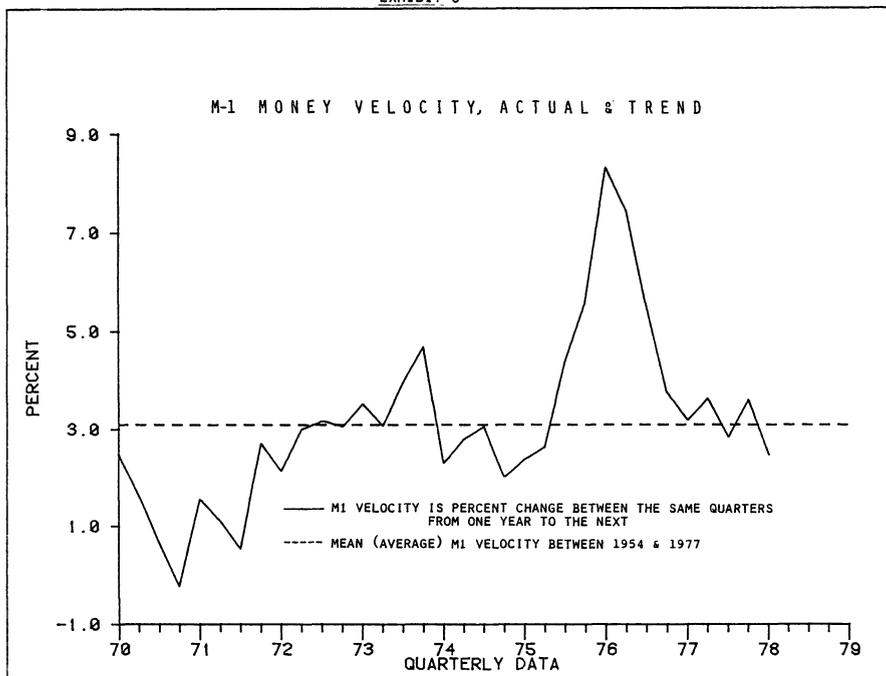


EXHIBIT 5. This graph compares the yearly percentage changes in the velocity of money (GNP divided by M1) with the average rise in velocity (3.1 percent) that occurred from the Korean War until now. The comparison is only graphed for 1970-78.

Changes in the rate of rise of velocity appear to be random around the 3.1 percent trend. It is therefore difficult for the Federal Reserve to anticipate these changes. It is also risky to count on having a specific velocity or to try to compensate for recent changes in the rate of rise of velocity, as these can quickly and unexpectedly reverse.

EXHIBIT 5



QUARTERLY HEARINGS ON THE CONDUCT OF MONETARY POLICY

MONDAY, AUGUST 7, 1978

HOUSE OF REPRESENTATIVES,
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Henry S. Reuss (chairman of the committee), presiding.

Present: Representatives Reuss, Mitchell, Derrick, Pattison, Cavanaugh, Watkins, McKinney, Kelly, Fenwick, and Leach.

The CHAIRMAN. Good morning.

The House Committee on Banking, Finance and Urban Affairs will be in order for its hearings on the Conduct of Monetary Policy, pursuant to the Federal Reserve Reform Act of 1977.

This morning we turn our attention to a sector of our economy which plays a crucial role during recoveries, the housing sector. The health of this sector of our economy is closely related to the level of interest rates.

Although we have been fortunate thus far this year in maintaining a fairly healthy level of new private home construction at something over an annual rate of 2 million units, the high mortgage rates threaten the continuation of this trend.

What can be done?

We have invited this morning the Secretary of HUD, Patricia Harris, and Robert H. McKinney, Chairman of the Federal Home Loan Bank Board, who I am sure will help shed some light on these important matters. We were informed this morning that Mrs. Harris will not be able to be with us.

For whatever it is worth, I ask that a story in this morning's Wall Street Journal entitled, "White House Boosts Campaign to Speak With Single Voice; Secretary of HUD Foregoes Hearing After Conflicts Over Proposed Testimony," be made a part of the record for such validity as it may contain.

[The article referred to follows:]

[From the Wall Street Journal, Aug. 7, 1978]

WHITE HOUSE BOOSTS CAMPAIGN TO SPEAK WITH SINGLE VOICE

SECRETARY OF HUD FORGOES HEARING AFTER CONFLICT OVER PROPOSED TESTIMONY

The Carter administration is stepping up its campaign to speak with one voice. Secretary Patricia Harris of the Department of Housing and Urban Development decided to forgo an appearance before the House Banking Committee today after a disagreement with White House staff members over her proposed testimony.

The committee hearing had been called to examine the effect of the Federal Reserve Board's monetary policy on housing. Mrs. Harris in the past has criticized high interest rates as holding down housing construction. Recently, a HUD task force recommended that the department be given a role in helping set monetary policy, to smooth out boom-and-bust housing cycles.

After reviewing Mrs. Harris's proposed testimony, White House staff members asked for a number of changes. "There was some concern over how that position was being articulated," a HUD spokesman said. Because of a shortage of time and "difficulties" in working out new testimony, he said, Mrs. Harris decided to skip the hearing.

This is one of several recent instances in which the White House has taken steps to assure that different parts of the administration don't take conflicting positions on an issue. Earlier, White House ordered presidential aide Midge Costanza to skip a scheduled television interview. She resigned last week.

The CHAIRMAN. Now, Mr. McKinney, we are delighted to have you. Your testimony and accompanying charts, which under the rule and without objection, will be received in full in the record.

Would you now proceed in your own way, and I am sure we will have some questions when you are through.

**STATEMENT OF HON. ROBERT H. MCKINNEY, CHAIRMAN,
FEDERAL HOME LOAN BANK BOARD**

Mr. MCKINNEY. Thank you, Mr. Chairman. I will proceed.

The CHAIRMAN. Has your testimony been cleared with the White House?

Mr. MCKINNEY. I have sent a copy to the White House, sir.

The CHAIRMAN. Has it been pronounced clean as a hound's tooth?

Mr. MCKINNEY. It has not been sanitized by the White House, no, sir. Out of respect for the White House, it is customary for most independent agencies to send them a copy but, of course, we don't ask for clearance. It is a nice position to be in.

The CHAIRMAN. Thank you very much.

Mr. MCKINNEY. Mr. Chairman and members of the committee, it is an honor for me to appear before you today to discuss monetary policy, its relationship to the Federal Home Loan Bank Board and, as a consequence, its relationship to housing.

Since the mission of the Bank Board is to provide leadership in meeting the housing finance needs of the American public, the conduct of monetary policy and its relationship to housing goes to the fundamental basis for existence of the Bank Board.

I will begin my testimony by praising Chairman Miller of the Federal Reserve. He stated before this committee that the Federal Reserve alone cannot reduce inflation to reasonable levels.

I join him in this conviction. The entire Government and private sectors must be brought into play. This calls for responsible fiscal policies and strong leadership from the executive branch and a strong response from the Congress.

I commend this Congress for the actions you have undertaken to reduce the deficit in fiscal 1979.

I have not been an admirer of all Federal Reserve monetary policies. In the past, these policies have often gone too far, gutting the housing industry in the process. Past Federal Reserve policy sometimes has placed too much faith in monetary aggregates and monetary policy as the solution to inflation.

I had some initial concerns about Chairman Miller's philosophy on this point, which I openly expressed. I see this as one of my responsibilities.

This Nation's economy is far, far too complex to have monetary policy do the job alone. I now believe that Chairman Miller has brought a fresh breeze of realism to Federal Reserve policies. I know he wants to exercise restraint. He does not want the Federal Reserve to bludgeon the economy to death while waging the battle against inflation.

An unrelenting effort to control the economy by monetary policy runs the severe risk of throwing the country into a recession, and in such times housing always seems to bear a disproportionate burden of economic difficulty. Today, I would like to outline how the Bank Board fits into and affects the conduct of monetary policy.

We must first examine the relationship of monetary policy to housing and to the mortgage market. Looking at interest rate movements in the past, we see a strong relationship between changes in interest rates and housing activity. We can also see that in the past there has been a strong correlation between housing activity and real economic growth.

Charts 1 to 4 in my written testimony present these relationships. The effects (1) of interest rates on savings flows, (2) of savings on housing starts, (3) of mortgage interest rates on housing starts, and (4) of housing starts on real GNP.

As these charts show, housing has been one of the most interest sensitive sectors of our economy. Housing is strongly affected by monetary policy, because monetary policy affects interest rates.

How does the Bank Board fit in? We are in a push-pull relationship with the Federal Reserve Board. When they take action which tends to push housing down, we take actions to pull housing back up. But we have also injected another ingredient. We try to predict the trends of interest rates in housing and work in advance with the Federal Reserve and others to keep housing from going into the tailspins that have marked the past.

In turn, when the Bank Board pulls for housing, its actions can exert upward pressure on interest rates. There is a feedback effect on monetary policy of what the Bank Board does for housing.

We use a number of tools to help housing. We make advances through the Federal Home Loan Bank System. These are loans to thrift institutions which they use for mortgage loans. We can lower liquid assets requirements for thrift institutions. This frees up additional moneys for mortgage loans. We pursue secondary mortgage market activities through the Federal Home Loan Mortgage Corporation. The Mortgage Corporation helps to channel funds from capital surplus to capital deficit areas. Also, because non-savings and loans buy a high proportion of mortgage corporation securities, we can increase the net amount of mortgage money flowing to thrifts.

Finally, the Bank Board, through rate control over savings accounts and the creation of new certificates, helps to bring in deposit money for mortgage loans.

The Bank Board can use all these tools to counter adverse cyclical trends in interest rates. We are using these tools—advances,

liquidity, Mortgage Corporation purchases and imaginative rate control and liability management—right now. We are using them to stabilize mortgage credit flows in this high interest rate period.

We have had to step up our activities because higher interest rates have produced a savings shortfall at S. & L.'s. Not enough money is coming in to meet mortgage demand.

To date, the Bank Board has met the shortfall using the tools I mentioned. Through advances we have supplied \$5 billion in the first half of this year. We are prepared to advance an additional \$6 billion for the remainder of the year. We have reduced required liquidity from 7 to 6½ percent, releasing up to \$2 billion in additional funds available for mortgage lending.

The Mortgage Corporation contributed a net of \$2 billion in mortgage funds during the first half of this year. Together with the other financial regulatory agencies, we sponsored a new, 6-month, money market certificate with an interest rate tied to the 26-week T-bill discount rate. This new certificate already appears to be successful in stemming further savings outflows and bringing in new funds.

Using these tools, the Bank Board has met the \$9 billion savings shortfall for the first half of this year. Thus the Bank Board has been able to support the continued strong flow of mortgage credit and housing sales which we have all witnessed this year. The predicted housing turndown has not occurred.

We have assumed present levels in projecting the \$15 billion shortfall figure. Our access to capital markets for the shortfall funds is not unlimited. Moreover, if interest rates do not go much higher than most analysts project, the Bank Board will be able to continue to make up the savings shortfall. In turn, this will assure a stable flow of mortgage funds.

I hardly need to remind this committee of the major unemployment in the housing sector caused by the credit crunch of 1974-75. The percentage of unemployed rose to staggering proportions, causing great human suffering and a ripple effect in many other industries. The Bank Board intends to do all it can to prevent such major recurrences in the future.

Let me summarize my testimony. The monetary policies of the Federal Reserve System and the housing support policies of the Bank Board are complementary. We moderate the effects of monetary policy on housing.

If present interest rate projections hold, the Bank Board will be in a position to assure an adequate flow of mortgage credit to the American public.

Stepping back from the immediate decisions which face us, we must redouble our commitment to a real fight against inflation. The corroding effects of inflation, in the end, can destroy our common desire for a robust economy in general and a strong housing industry in particular.

Thank you for your kind attention. I will be happy to respond to questions.

[Mr. Mckinney's prepared statement on behalf of the Federal Home Loan Bank Board, with accompanying charts follows:]

TESTIMONY ON THE CONDUCT OF MONETARY POLICY

By

Robert H. McKinney

Chairman

Federal Home Loan Bank Board

Before The

U.S. House of Representatives

Committee on Banking, Finance, and Urban Affairs

August 7, 1978

INTRODUCTION

I appreciate the opportunity to meet with you today to give this report on the Conduct of Monetary Policy and on its effects on national housing markets. First, may I reemphasize what Chairman Miller pointed out in his testimony before this Committee. Our most serious economic concern today is inflation.

We at the Bank Board concur that failure to contain and control future price increases will bring about serious allocative distortions and promote economic instability. We are particularly concerned as to the adverse impact of continued inflationary increases on the ability of our financial system to supply adequate funding to the housing sector of this country.

This is a concern which Chairman Miller recognized. Inflation places a serious burden on young, low, middle income families and all prospective homeowners. We concur also with Chairman Miller that monetary policy alone cannot lighten the burden of inflation. Increased fiscal responsibility must be shown at all levels of government.

IMPLEMENTATION OF MONETARY POLICY

In setting monetary policies, Chairman Miller and his colleagues on the Federal Open Market Committee(FOMC) and the Federal Reserve Board must take into account a broad range of economic objectives. These include full employment, price stability, balance of payments, and economic growth as well as the impact of these policies on particular sectors of the economy, such as housing, and the feedback effects of these actions.

The task of the Federal Reserve System is a difficult one in attempting to develop a comprehensive view of the economy and in deciding how much emphasis to give to various conflicting economic goals in the conduct of monetary policy. Uncertainties abound. For example, the Federal Reserve System is still uncertain as to the final shape of legislation to reduce Federal income tax revenues and has had to deal with that uncertainty for the entire year.

This is not to say that I have not been critical of Federal Reserve policies in the past - I have. Often I have felt that monetary policies were overly restrictive, and as indicated in Chart 1, the Federal Reserve has at times in the past pushed interest rates abnormally high, leading to considerable instability in financial markets. There was a time in the not too distant past when some of those who determined monetary policies apparently thought that such policies alone could contain inflationary pressures. The consequences were most unpleasant as you all remember. So, I was pleased to note that throughout his testimony last week, Chairman Miller quite correctly emphasized the risks of restrictive monetary policies.

The FOMC has in recent years set monetary growth ranges and revised these on a regular basis as a means of indicating the thrust of monetary policy.

Target ranges are adopted for three major measures of monetary aggregates. These are M1, demand deposits and currency; M2, including both M1 and time and savings deposits, other than large CDs, at commercial banks; and M3, which includes M2 and deposits of thrift institutions, the bulk of which are held at savings and loan associations.

The FOMC adopts higher monetary growth targets during periods when the economy is sluggish and unemployment is high, and generally adopts low monetary growth targets when economic conditions are of the opposite type.

However, as noted above, the Federal Reserve has conflicting objectives, and the high rate of inflation has led the Federal Reserve System to maintain lower monetary growth ranges than would be the case based on considerations of economic growth and unemployment alone. Also, as this Committee well knows, the growth of monetary aggregates does not always fall within the ranges specified by the FOMC. Indeed, M1 has over the past year grown beyond its specified range even though the broader definitions have not.

The FOMC attempts to control the rate of monetary growth primarily through its open market operations in U.S. Government securities. Because of the complexities of controlling directly the reserve base that affects monetary expansion, the FOMC has its open market manager conduct open market operations so as to meet short-term targets in the federal funds rate.

From time to time the federal funds target is changed, which has an impact on other interest rates in the economy. Some Federal Reserve watchers put primary emphasis upon movements in the federal funds rate to determine whether monetary policy is easy or tight. Others put more emphasis upon the monetary growth targets themselves as being the more basic expression of Federal Reserve policy.

I would prefer not to get involved in the question of whether interest rates or monetary aggregates represent the best way of measuring monetary policy. However, I can say with a great deal of confidence that it is interest rates that affect housing markets, and the Federal Home Loan Bank Board is, of course, concerned very much with the impact of changes in interest rates on the level of housing activity. It is in this context that I shall concentrate the remainder of my remarks.

RELATIONSHIP OF MONETARY POLICY TO HOUSING AND MORTGAGE MARKETS

If we look at historic interest rate movements, we find that there has been a strong correlation between such changes and housing activity, and between housing activity and real economic growth. Charts 1-4 shows this relationship by looking at movements in interest rates, savings flows, housing starts, mortgage rates, and changes in real GNP.

The link among these charts is amplified by the flow chart (Chart 5). Federal Reserve policies directly determine interest

rates which in turn impact net new savings receipts at savings institutions.

As shown in Chart 1, over the past twelve years this has exhibited a repetitive cyclical pattern, with savings flows basically moving inversely with interest rate movements. As suggested in Chart 2, net new savings flows impact the important housing sector. These changes in savings flows do not always move one-for-one with housing starts. However, the general tendency of housing starts to fluctuate with the changes in savings inflows to S&Ls is evident from the chart.

This linkage is shown more directly in Chart 3 in which mortgage rates are graphed against housing starts. Again, this cyclical pattern is evident, although as you know, events in the past few months would seem to suggest that this pattern has been broken and that the housing sector has developed immunity to the vagaries of the money markets. This is not the case, although a number of actions taken by the Bank Board since the last tight credit period have mitigated significantly the adverse impact on housing of rising interest rates.

Finally, Chart 4 links the cyclical pattern of housing, as measured through housing starts, with overall economic activity, as measured by changes in real GNP. Because adequate housing is one of the primary factors which lie at the foundations of our social structure, it is not possible to assay completely the overall value of housing in this country.

I would, however, like to call the Committee's attention to a few figures which point out the importance of housing as a factor in our overall economy. To begin, residential construction amounted to \$92 billion in 1977, which was 31% of gross private domestic investment. Housing output, which essentially consists of rents and imputed rents to owner occupied dwellings, accounts for 15% of personal consumption expenditures, or approximately \$180 billion in 1977. This amounted to 10% of GNP. If we now allow for housing related expenditures--referred to in the National Income Accounts as "Household Operations"--then these housing and housing related outlays account for 30% of personal consumption expenditures, or between 19-20% of GNP. Thus, housing's role in the stability and growth of our economy is very important, not to mention the enormous social benefits flowing from an adequately housed nation. Restrictive monetary policy imposes a heavy burden on the important housing sector while attempting to stabilize the entire economy.

My major message to you today is to focus on the role of the Bank Board in dealing with this situation in attempting to moderate the impact of monetary policy on housing.

Monetary policy is supposed to operate by discouraging interest-sensitive expenditures during periods of economic boom and encouraging such expenditures during periods of slow economic growth. In practice, residential housing expenditures have been among the most interest sensitive types of expenditures in the economy, as indicated above. Thus, aggressive monetary policy has had a destabilizing influence on housing activity.

As a result of the tight credit period in 1966, which produced the first major period of disintermediation for S&Ls, housing starts declined by 49 percent in a one-year period as short term rates increased by nearly 20 percent in only three months. The tight credit period of 1969 produced a 39 percent decline in housing starts. An even more rollercoaster example of the effect of monetary policy was the strong advance in housing starts in the early 1970's, followed by the tight credit periods of 1973-74, which produced a decline in housing starts of about 64 percent, with federal funds rates rising to over 13 percent, and the prime rate climbing to 12%.

The link between Federal Reserve policies and housing are inextricably entwined with the savings and loan industry. I refer the Committee again to Chart 5 in order to spell out more fully the nature of the process and to develop in greater detail the impact of monetary policy on housing through the Bank Board System and the savings and loan industry. The link here is essentially three-staged: from interest rate effects to savings flows, from savings flows to mortgage lending, and from mortgage lending to housing finance and housing starts.

In order to place the role of savings and loan associations in perspective, I should point out that the importance of S&Ls in providing residential mortgage credit has increased substantially since the end of World War II, as is evidenced in Chart 6. More specifically, savings and loan associations have not only been

the dominant mortgage lenders on one-to-four family structures, but in recent years have been a major lender on apartment structures as well. This means that factors influencing the flow of funds through savings and loan associations have become increasingly important in affecting the level of total housing activity.

After World War II, there was an era of rapid and reasonably stable growth for S&Ls that lasted until the mid-1960s. Beginning with 1966, savings flows through S&Ls have taken on a very unstable configuration. This has reflected the much greater sensitivity of S&Ls to general financial market developments and the increased interest rates sensitivity of S&L depositors.

The first major disintermediation period, 1966, reflected both a diversion of funds from S&Ls to commercial banks and an outflow of S&L funds into open market obligations, such as U.S. Government securities.

The imposition of rate controls on consumer-type deposits in September 1966 was designed to minimize or eliminate the diversion of funds from S&Ls to commercial banks during tight credit periods. In such periods, the rate differential becomes increasingly important in that competition between thrifts, commercial banks, and other financial seekers of funds becomes more intense. As escalating yields on open market instruments begin to induce disintermediation, it is especially important that thrifts not be as subject to the pressures of rising rate competition, since the many restraints which continue to exist on the asset and liability powers of

S&Ls, admittedly dictated by broad government policies, limit their ability to compete with other institutions and instruments during such periods.

Since 1966, savers have become more aware of open market obligations as alternative savings media. The development of money market funds, and funds that invest in longer term corporate and municipal securities have made it easier for savers to shift their funds out of S&Ls.

We have not put an end to the problem and dangers of disintermediation, even with the recent changes in the liability powers of thrifts. The substantial instability in savings flows of S&Ls since 1966 has put a burden on Bank Board policies in stabilizing housing credit and housing activity. This in turn has given the Bank Board a role in the housing market that is analogous to that of the Federal Reserve System with respect to the general economy.

RELATIONSHIP OF MONETARY POLICY AND BANK BOARD POLICY ACTIONS

This brings me to a discussion of recent and current developments, and the way in which the Bank Board has responded in attempting to stabilize the flow of housing credit.

The primary reason for the establishment of the Federal Home Loan Bank System was to promote stability in housing credit. At the present time, the Bank Board has a number of very important tools by which it can influence housing. The first is through advances that represent funds lent to member institutions,

primarily savings and loan associations. The second is through changes in liquidity requirements of member institutions which affect the amount of funds that these institutions can put into the mortgage market. The third is through the purchase and sales of mortgages by the affiliated Federal Home Loan Mortgage Corporation (the Mortgage Corporation). The fourth is through rate ceilings on savings and time accounts and the ability to create new types of accounts with new ceiling rates.

It is important for this Committee to have an understanding of the feedback effects of Bank Board policies and activities on Federal Reserve policies with regard to interest rate targets.

As I have stressed, Bank Board policy for the stabilization of mortgage and housing markets depends heavily on the status of Federal Reserve monetary policy; but in turn, Bank Board policy exerts feedback effects on monetary policy. As noted previously, tight monetary policy places a burden on the housing sector, perhaps more so than on any other sector in the economy.

Bank Board policy actions are designed to alleviate that burden somewhat. While tight monetary policy attempts to dampen economic activity in general, Bank Board policy attempts to bolster the housing market in particular. Consequently, expansionary Bank Board policy does generate feedback effects which run contrary to a contractionary monetary policy.

Again, Chart 5 illustrates this relationship between Bank Board policy and Federal Reserve policy. Federal Reserve policy sets certain money growth and interest rate targets, which in turn affect the flow of savings to thrift institutions. Tight monetary policy, as reflected in high interest rates, reduces savings flows which in turn reduce mortgage lending and housing starts. Bank Board policy responds to these developments in several ways.

Two short-run policy tools are the extension of advances to S&Ls and the purchase of mortgages by the Mortgage Corporation. However, both of these actions require the sale of financial instruments in order to finance these activities. The Bank System sells debt in the form of consolidated bonds and discount notes to finance advances. Similarly, pools of mortgages that have been purchased by the Mortgage Corporation are "sold" through Participation Certificates and Guaranteed Mortgage Certificates.

This financing activity inevitably exerts feedback upon monetary policy by creating upward pressure on interest rates. An exception to this is the Bank System's use of member deposits. By accepting deposits from members having excess liquidity, the Bank System is able to fund advances without placing further pressure on the agency security market. As of the present, the Bank System has raised \$6 billion in this manner, which is already 50% above that raised in 1974.

There are also a number of long-run policy actions that have been implemented in recent years. These include the money market certificates, NOW accounts, early withdrawal penalties on savings certificates, Jumbo certificates, and rate ceiling revisions to increase the certificate/passbook mix at S&Ls. Collectively, these changes have affected Federal Reserve monetary policies by making S&L savings flows less sensitive to rising interest rates. Thus, mortgage lending and housing construction are less susceptible to the adverse effects of rising interest rates, which in turn have reduced the needs for external financing by the Bank System.

RECENT BANK BOARD ACTIONS TO STABILIZE AVAILABILITY OF HOUSING CREDIT

I return now to look at some of the anticyclical tools of the Bank System within the context of recent interest rate increases and growing adverse market pressures on savings flows.

As shown in Chart 1, interest rates have been on the rise almost continually since early 1977. A number of special factors sustained the level of savings flows during the third quarter of 1977, but by the fourth quarter, savings flows begin to decline on a seasonally adjusted basis. During the first half of this year, net savings flows of S&Ls, including interest credited, has been \$22.3 billion, compared to \$27.8 billion during the first half of 1977, a decline of nearly 20 percent.

The drop in savings flows that has occurred has been significant but has been less than might be expected during the period when the three-month Treasury bill rate has gone from under 5 percent to over 7 percent. Clearly, the lengthening of the liability structure of S&Ls is producing a greater degree of stability in savings flows.

As shown in Chart 7, only 37 percent of savings accounts of S&Ls are in passbook accounts, compared to nearly 90% in 1966. With the creation of savings certificates in recent years, the bulk of the flow into S&L accounts has been into long-term certificates. This in turn has effectively locked large deposit balances into S&Ls because of penalty rates involved in premature withdrawals.

Another important factor has been a significant increase in the use of large negotiable CDs that carry no interest rate ceilings as a means of accessing credit markets. These so-called "Jumbo" certificates have accounted for more than 10 percent of total deposit growth during the first half of this year. At the present time, "Jumbo" CDs represent almost three percent of total savings and are at record levels.

As suggested in Table 1, housing finance demand has remained high throughout this current upward cycle in rates. The Bank Board has been very supportive of the need of S&Ls for funds during this tight credit period, as indicated in Chart 8, which graphs sources of funds to insured S&Ls for the first

six months of 1977 and 1978. There has been a strong demand for housing, reflecting a high rate of household formation and a bulge in age groups that normally prefer homeownership. Census figures show that 42 percent of the average annual increase in the number of household heads, over the period 1974-1980, are in the 25-34 year old bracket. This compares to 22 percent of household heads which are currently in that same age bracket. In addition, many households have been purchasing homes because of a greater investment mentality as they have recognized the appreciation potential of homeownership.

Although, as I pointed out above, a changing liability power and a correspondingly changing liability structure have acted toward mitigating disintermediation pressures, the S&L industry nonetheless has experienced a significant drop-off in savings flows during this year. Chart 9 illustrates the magnitude of this savings shortfall relative to a stronger savings growth pattern under a structure of lower interest rates.

In this chart, the broken line represents our projections of what savings would have been thus far this year, and what savings would likely have been for the latter half of this year, if interest rates had stayed at levels exhibited in 1977; that is, federal funds at an annual average of 5.5%, and 91 day T-Bills at an average of 5.3%.

The solid line shows actual savings capital at S&Ls through second quarter 1978 (1978-II) and the Bank Board's projection through the 4th quarter. Based on this, net savings flows during the first six months of 1978 are estimated to be about \$9 billion less than they would have been had monetary conditions not tightened. The projected shortfall in savings by year-end is estimated at \$15 billion under this comparison.

If we use a slightly more pessimistic forecast, such as one held by 20 percent of respondents in the latest Goldsmith-Nagan survey on interest rate expectations, the savings gap between expected savings flows and savings flows under this pessimistic rate structure becomes even larger, as shown by the dotted line in Chart 9. This more pessimistic view holds that Federal funds rates will be over 9% at year-end, 50-75 basis points higher than in our present scenario, which is that short term rates will begin to turn downward in the 4th quarter of this year and that the federal funds rate will peak around 8.5 percent. The result would be an even larger savings shortfall--\$18 billion --as opposed to our present estimate of about \$15 billion.

The primary reason mortgage lending has been maintained at its current level is that through the advances mechanism, the Bank System has increased its loans to S&Ls by \$5 billion in the first half of 1978. This was after an increase of \$4 1/2 billion in the second half of 1977. Plans at this time call

for an additional \$6 billion of advances by year-end if interest rates continue to rise as under our scenario. Already in July, the Bank System has loaned another \$1.3 billion. This means that by year-end, our advances outstanding will have doubled since mid-1977.

The second major action taken to combat the tightening monetary condition was the reduction of the liquidity requirement from 7% to 6 1/2% on May 1. This action reduced the amount of securities which S&Ls are required to hold as a liquidity reserve backing their deposits. As a result of this Bank Board action, more than \$2 billion of funds were made available for mortgage lending.

A third major action we have taken is through purchases of mortgages by the Mortgage Corporation. Total commitments to purchase mortgage loans by the Mortgage Corporation through June of this year amounted to \$3.47 billion; total purchases accounted for \$2.44 billion. Commitment sales as of June were \$3.00 billion. Currently 88 percent of commitments to purchase have been to savings and loan associations, and 67 percent of sales have been outside of the S&L industry, which incidentally is up from 58 percent in 1977. Thus on net, the Corporation has pumped \$2.07 billion into associations during the first half of this year.

These three policy actions--advances totaling \$5.0 billion, reduced liquidity requirements freeing \$2.0 billion,

and Mortgage Corporation purchases of \$2.0 billion--have acted to offset the \$9 billion of savings shortfall as of the first half of this year. As a result, mortgage lending continued at a healthy pace during the first half of this year and provided the necessary financial support so that housing markets could continue their present pace of activity.

We are less confident of our ability to maintain the projected level of mortgage lending the second half of this year if interest rates continue to rise as per our scenario. The effects of our scenario are several. If rates continue to rise, the Bank System will be forced to issue more consolidated bonds. This will increase our cost of debt as well as place further pressure on capital markets. The Mortgage Corporation will be forced to either cut-back its purchasing operations or further subsidize mortgage purchases above current levels. It cannot continue to do this indefinitely.

So to summarize, we have been successful in the first half of this year, through the actions described above, in maintaining

a steady flow of funds into housing in spite of rapidly rising interest rates during that period. We are not as confident of our ability to do so in the second half of 1978 if rates rise too much further.

MONEY MARKET CERTIFICATES

In addition to these three actions, the Bank Board, in conjunction with other financial regulatory agencies, developed and introduced on June 1 a new savings certificate that is specifically designed to make S&Ls less susceptible to the ill effects of tight monetary policy.

The so-called money market certificate is a short-term certificate whose interest rate ceiling is set weekly for S&Ls at 1/4% over the discount rate on newly-issued, six-month Treasury bills. It is designed to enable S&Ls to compete with open market investments during periods when the yields on those instruments exceed the yields on traditional thrift institution certificates whose rate ceiling change infrequently. To date, the money market certificate appears to be quite successful in abating savings funds outflows.

During June and July, net new savings receipts at insured associations were about 80% larger than would have been the case if savings flow had continued at the April-May seasonally

adjusted pace. This understates the impact of the new savings certificates since in all probability, savings flows would have declined from the April-May rate over the past two months without the introduction of the new accounts because of the further rise in market interest rates.

On the other hand, some of the recent flow into the new money market certificates clearly represents initial funds shifts caused by the introduction of a new and different savings instruments which will not be repeated in the future.

Data we have obtained from a sample of large associations indicates that institutions holding about 41 percent of insured associations' savings issued \$4.9 billion of the money market certificates from June 1 through July 20. More complete figures in terms of coverage show an estimated \$6.5 billion of these certificates issued at all thrift institutions in June. Somewhat more than 40 percent of the funds in such accounts at S&Ls is estimated to be new money (i.e., not transfers from existing accounts at the institutions).

ALTERNATIVE MORTGAGE INSTRUMENTS AND MONETARY POLICY

All the actions which the Bank Board has and can take with regard to assuring steady flows of funds into housing during tight money periods are not limited to liability powers. Instability in the housing finance section is linked not only to borrowing short, but to the lending long aspect as well. Accord-

ingly, I would be remiss if I did not comment on Alternative Mortgage Instruments (AMIs).

On July 24, the Bank Board issued proposed regulations on new mortgage instruments for the purpose of promoting discussion on them. The effect of these new mortgage instruments on monetary policy was studied in the Alternative Mortgage Instruments Research Study (AMIRS), sponsored by the Bank Board. It concluded that the only instrument of major concern would be the variable rate mortgage (VRM).

VRMs are already in existence in a number of states. The Bank Board proposal permits the VRM offerings in those states not only to achieve a competitive balance between federally chartered S&Ls on the one hand, and state-chartered S&L and commercial banks and national banks on the other, but more importantly, to set a national pattern of consumer safeguards for these instruments. The proposed regulations limit the extent to which Federal S&Ls can invest in VRMs, and there is evidence suggesting that even in an unfettered market, VRMs would not predominate over other mortgage types. Thus, at least for the next several years, VRMs should have no substantial effect on housing markets, and thus on monetary policy. In the longer run, we are confident that the Federal Reserve can adjust to the slowly evolving financial environment in which S&L asset and liability powers are broadened.

One other point is relevant here. Arguments have been made that VRMs are inflationary. We strongly dispute these arguments. The argument itself is based on two assumptions: (1) higher long-term interest rates are inflationary; and, (2) lenders can manipulate the VRM index.

That higher interest rates are inflationary ignores the role of higher interest rates in reducing the demand for investment and consumer durable goods, which tends to lessen inflationary pressures; and, more importantly, it ignores the fact that interest rates are higher because of inflationary expectations, as opposed to being a cause of the future inflation.

As to the second point, the Bank Board has proposed specific regulations that would rule out any possibility of S&Ls manipulating the VRM index rate. It would be impossible for S&Ls to manipulate any money market rate based index. Even if a lender were able to use its own cost of funds rate as the VRM index (as state-chartered S&Ls could do if permitted by the state, and as national banks may be able to do now), competition, adverse publicity, and loss of existing and future loan customers would prevent the lender from arbitrarily increasing the VRM rate. Another feature of the Bank Board's proposed regulation allows prepayment without penalty whenever the outstanding VRM rate is above its initial rate. This alone will tend to hold down the extent to which any lender, if allowed, would increase its VRM rate.

One final point deserves emphasis. By the creation of the money market certificate, savings and loans were given a valuable variable rate tool to retain and to gain funds for housing. This will have an effect on their earning capacity, but it was judged a necessary move to counteract major disintermediation. As a consequence of this, the VRM takes on added importance.

CONCLUSION

In conclusion, I think that it is fair to say that at least from the vantage point of the industry which the Bank Board regulates, S&L mortgage lending has been proceeding at a steady pace thus far because of Bank Board actions to counter the ill effects of rising interest rates. While this experience may temper our apprehension over tightening monetary policy somewhat, it does not eliminate our concern over the future course of monetary policy.

Ultimately, the effects of rising interest rates throughout the economy spill over into the mortgage market. We cannot insulate mortgage and housing markets from general economic conditions indefinitely. Already mortgage rates have risen to record heights, reflecting tightening monetary pressures and inflation. The danger signs of previous tight credit periods are clearly present.

We realize that the Federal Reserve Board must consider the overall condition of the entire economy and, if inflation worsens, they will take those actions they judge to be appropriate.

The Bank Board has the responsibility of ensuring that housing does not bear a disproportionate share of the burden of economic stabilization, for we clearly understand the importance of housing to the social and economic well-being of this country.

Our policy actions thus far this year have been in recognition of that responsibility.

I hardly need to remind this Committee of the major unemployment in the housing sector during the last credit crunch. The percentage of unemployed in many communities rose to staggering proportions, causing great human suffering and a ripple effect in other industries. The start up time when funds do become available is lengthy, causing continuing damage to the economy. The Bank Board intends to do all it can to prevent such major economic upheavels in the future.

As I stressed at the outset, in the long-run we realize that inflation is the cause of escalating mortgage rates and housing prices, and we continue to support prudent monetary and fiscal policies to fight inflation.

Thank you, and I will be happy to answer any questions which you may have.

Chart 1. Average Interest Rate on New Issues of 91-Day Treasury Bills, and Net New Savings Receipts (Seasonally Adjusted) at FSLIC-Insured Savings Associations--1966-1978, by Quarter

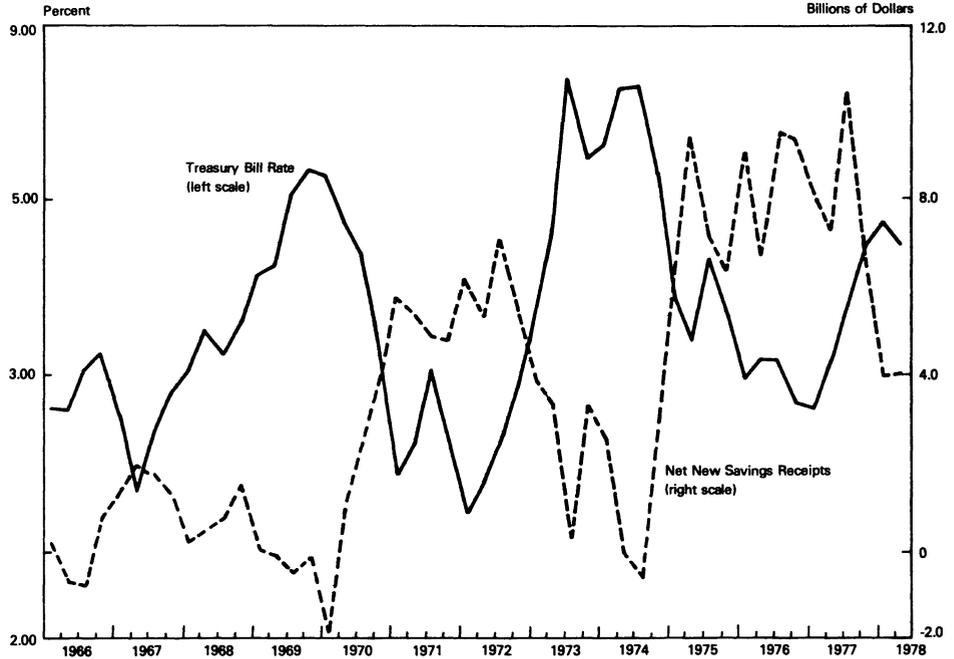


Chart 2. Net New Savings Receipts (Seasonally Adjusted) at FSLIC-Insured Savings Associations, and Private Housing Units Started (Seasonally Adjusted Annual Rate)--1966-1978, by Quarter

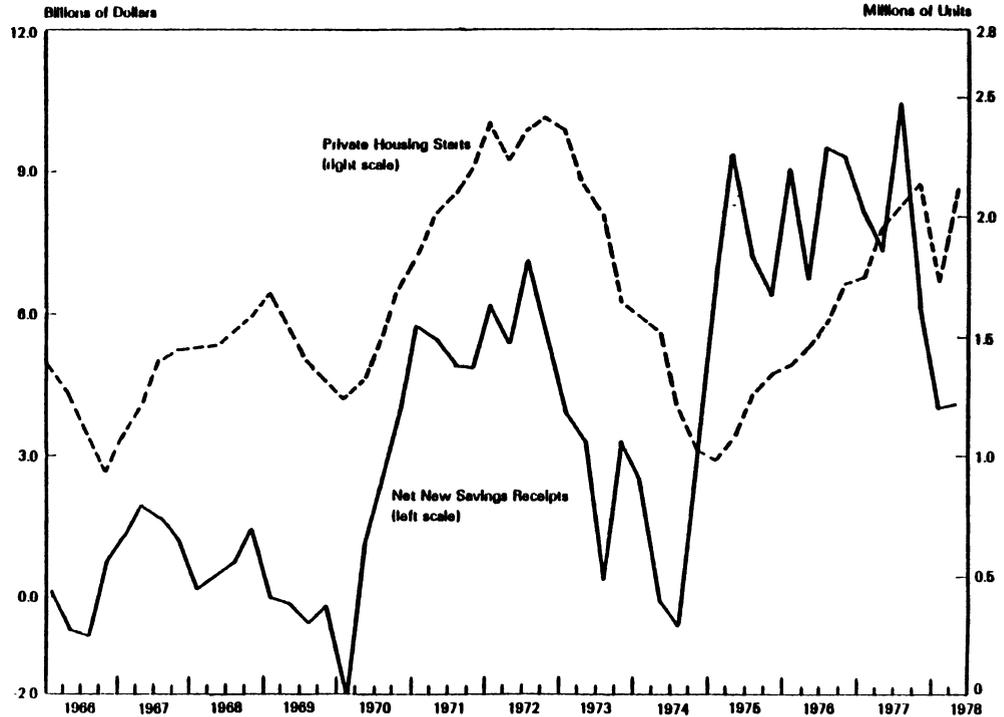


Chart 3. Effective Interest Rate on Conventional Mortgages on Newly-Built Homes, and Private Housing Units Started (Seasonally Adjusted Annual Rate) --1966-1978, By Quarter

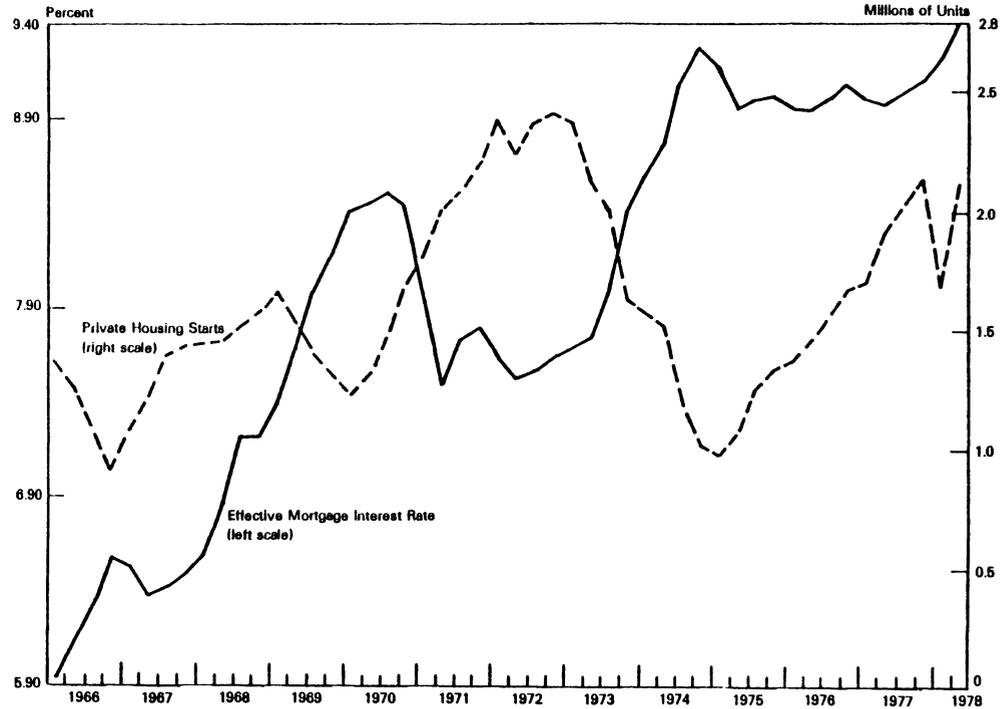


Chart 4. Private Housing Units Started (Seasonally Adjusted Annual Rate), and Change in Real Gross National Product (Annual Rates)--1966-1978, by Quarter

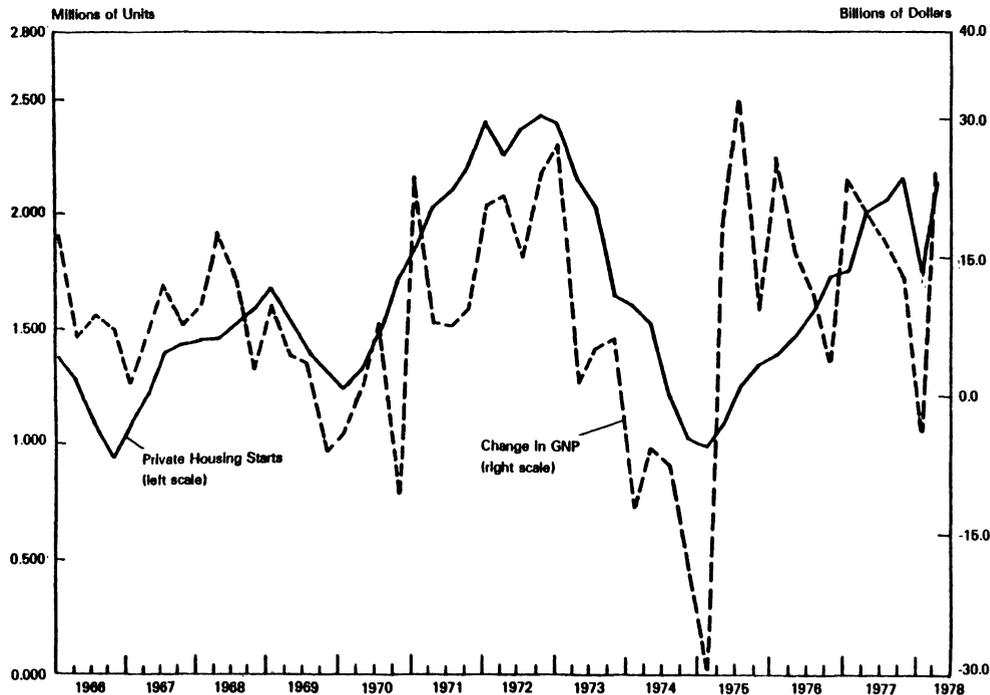
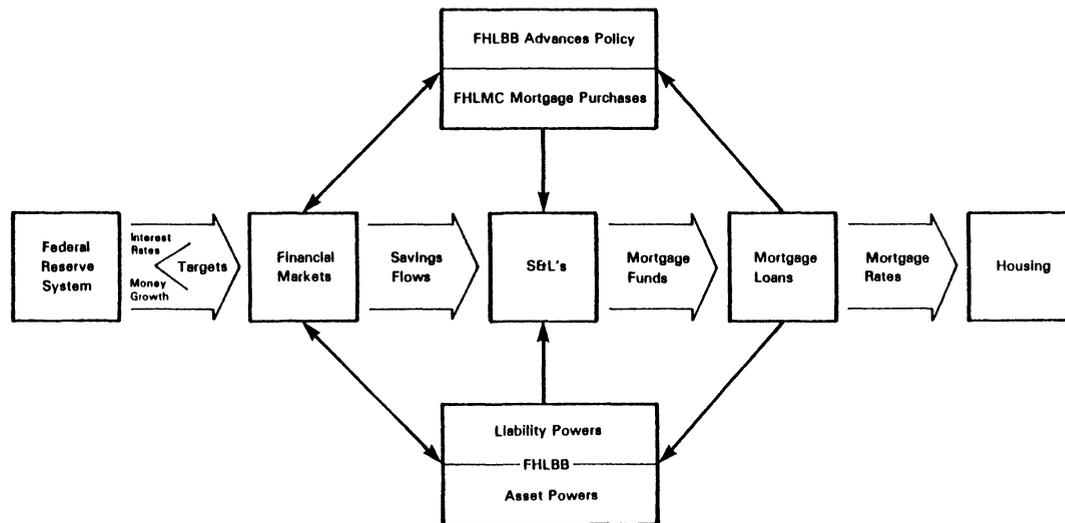
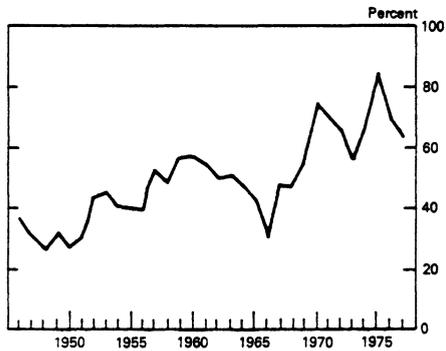


Chart 5. Federal Reserve Policies Linked with FHLBB Policies, Savings Flows, and Housing



**Chart 6. Savings and Loan Association Share of Net Increases
in Privately Held Home Mortgage Debt
--Annually 1946-77**



34-132 291

Chart 7. Liability Structure of FSLIC-Insured Savings and Loan Associations--Percentage Distribution; March 1966 and March 1978

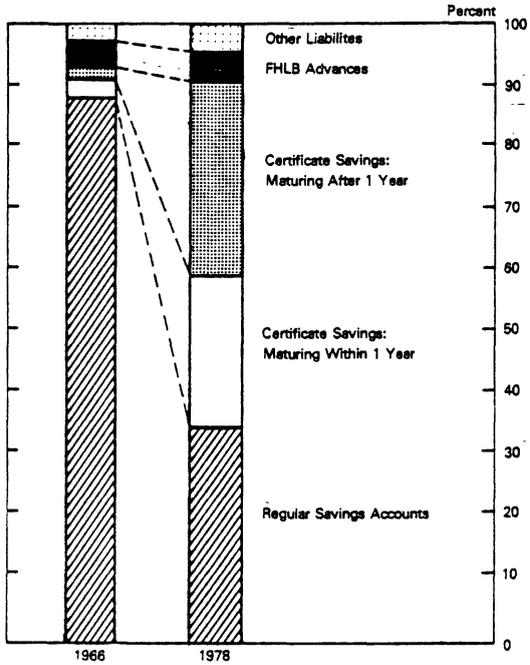


Chart 8. Sources of Funds of FSLIC-Insured Savings and Loan Associations
--January-June, 1977 and 1978

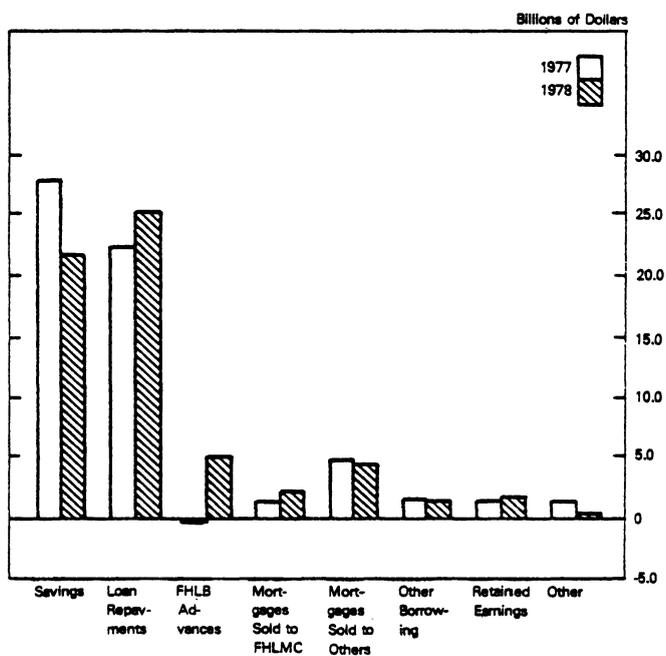
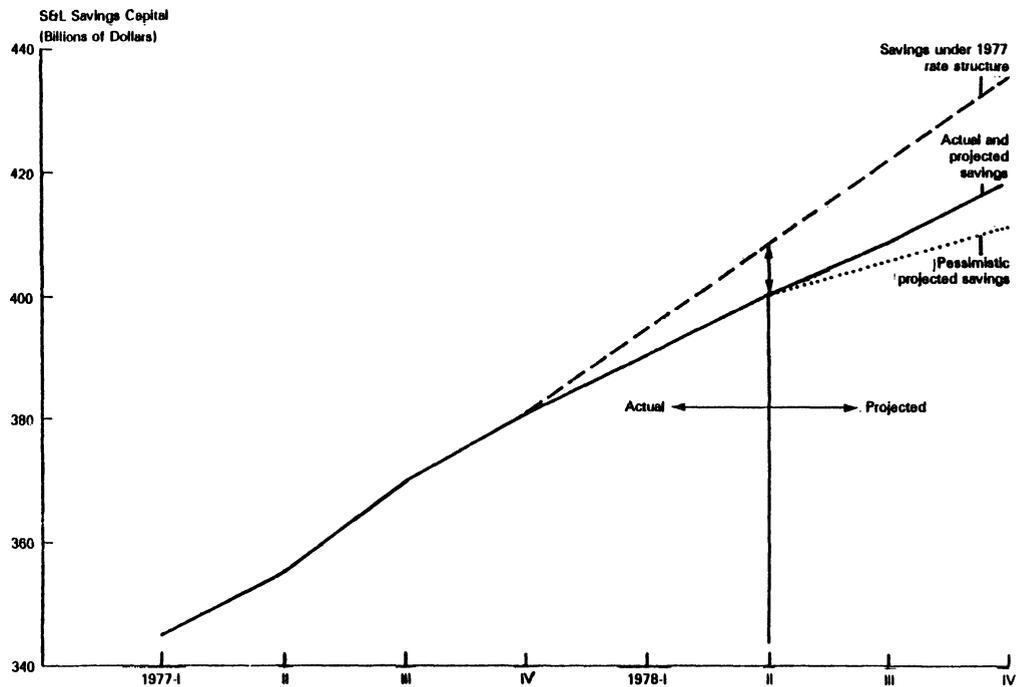


Chart 9. Savings Flows Projections and Estimated Savings Gaps Under Alternative Monetary Policies



The CHAIRMAN. Thank you very much, Mr. McKinney, both for your very succinct and hard-hitting summary and for your fuller statement.

Let's look at a very important statement you make on page 17 of your paper in which you have just gotten through at that point in telling how you have held your finger in the dike for the first 6 months of this year and kept the housing market from disintegrating despite rather sharply increasing interest rates.

You then say:

We are less confident of our ability to maintain the projected level of mortgage lending the second half of this year if interest rates continue to rise as per our scenario.

The effects of our scenario are several. If rates continue to rise, the Bank System will be forced to issue more consolidated bonds. This will increase our cost of debt as well as place additional pressure on capital markets. The Mortgage Corporation will be forced either to cut back its purchasing operations or to subsidize further mortgage purchases above current levels. It cannot continue to do this indefinitely.

This, put in delicate language, is very disturbing news, because there is a considerable possibility that the scenario may come true; is there not?

Mr. MCKINNEY. Mr. Chairman, as I said, I am not trying to be an alarmist; I am trying to be practical and a realist.

Our scenario is a hopeful scenario. I think we show in the final chart, chart 9 approximately what the shortfall is, and the fact is that if rates don't climb too much more we can handle the financing.

I am hopeful that is going to happen. Of course, if rates do go far beyond that we will have trouble fulfilling our requirements. If rates, for example, continue upward another 75 to 100 basis points, disintermediation in the savings and loans will become substantial.

In the savings and loans repayments will also shrink. And our access to the capital markets will be more difficult. There could be, of course, a serious problem.

The CHAIRMAN. Could you put the mike a little closer to you, Mr. McKinney?

Mr. MCKINNEY. Yes, sir.

Of course, our present hope is that the Fed funds rate will not rise above present levels. There are various projections of what it could do and might do.

Earlier in the year we made our projections for the year. From those projections we felt we could handle the shortfall in savings resulting from increased interest rates, if the Fed funds rate did not go above 8½ percent. So, as you can see, we are only about 55, 60 basis points away from that now.

I hope it won't go above that point.

Now, if the Fed funds rate did go to say 9 percent or 9¼, another 50 or 75 basis points above what our projections had been earlier, then a number of things would happen. Much greater disintermediation would affect the savings and loans, although the money market certificate that I talked about would help some. Because lending would slow down, repayments would slow down, and, as you have seen in one of our charts, repayments are a big source of funds.

Our ability to have access to the capital markets along with all of the other agencies will be restricted. I am not a prophet of doom

at all, but if these things should happen, there is a limit to what the banking system can do, our banking system can do.

The CHAIRMAN. You have played most of your cards, is what you are saying?

Mr. MCKINNEY. No, sir, we have cards left to play. As I said, I am not trying to be a prophet of doom, I am trying to point out realistically what can happen if things go certain ways.

The CHAIRMAN. Now, in his testimony before us within the last few days Chairman Miller of the Federal Reserve specifically turned down the suggestion that had been made by some that the upper limit on M_1 be raised from its present 6½-percent level.

Mr. MCKINNEY. I am familiar with that.

The CHAIRMAN. In fact, the actual creation of M_1 has considerably exceeded that for a long period of time, as long as 2 years.

Mr. MCKINNEY. Yes, sir.

The CHAIRMAN. Wouldn't the Federal Reserve, making good on its threatened target, present just the kind of scenario which would put you into the kind of housing bind which you have just described?

Mr. MCKINNEY. That is why I commended Chairman Miller—I understand from his testimony that they have not increased the range in M_1 . If they were determined to stick with that range, very likely that could drive rates up to what I am talking about; that is correct.

The CHAIRMAN. But what shall it profit the country to have a range which is consistently exceeded in the actuality? Do you want the Fed to stick, starting tomorrow, within that 6½-percent range, as if they mean what they say, which many think they would do?

Mr. MCKINNEY. Mr. Chairman, there is disagreement over what factors should go into the M_1 range.

What I think Chairman Miller has said is that there is a body of opinion that the M_1 figures are not always that exact. Therefore, they should be used over a much longer period of time.

I would be very unhappy, if they tried to stick very tightly to the M_1 range they now have. I think that could cause some problems. I don't think they intend to do that; I think they intend to take a broad look.

I realize that it is troublesome to some, that when a range is established, it is not necessarily observed. Fortunately, since it is not my range, I am free to criticize.

The CHAIRMAN. Are you suggesting the Fed is deliberately trying to hoodwink the press and public?

Mr. MCKINNEY. No, sir; I am not.

The CHAIRMAN. But then how can they quarter after quarter project ranges which they don't even come close to keeping, and how can you be so blithe about a situation where they month after month, quarter after quarter, indeed, year after year exceed their own sacredly proclaimed ranges?

Mr. MCKINNEY. I am not blithe about it at all. I think they have kept within the range on M_2 and M_3 , which they also regard as important. I think the M_1 range is a range that they feel has to be regarded from a long-term perspective cannot be taken quarter by quarter.

Unfortunately, for the last three or four quarters they have not met it very well.

The CHAIRMAN. They have not met it at all.

Mr. MCKINNEY. I am not in the position of saying what the range ought to be. I am not a Governor of Federal Reserve. I do think that if they tried to take a very arbitrary position on what the range should be, they would end up tightening monetary policy too much, and we would have the housing problems I discussed.

The CHAIRMAN. Would you really want to use the word "arbitrary" to describe a man doing what he says he is going to do?

Mr. MCKINNEY. My understanding is that Chairman Miller has every intention of carrying out the mandate to follow the M_1 restraints as closely as possible, but that he believes they should be looked at in long-run terms and not just on a weekly or monthly basis. He thinks that over the next four quarters, if I remember what he has said recently in the press, that it gradually will come back to this range.

Now, of course, one answer could be that they raised the range. But he is dealing with pressures from the entire Board of Governors, and I assume there was some pressure not to raise the range.

The CHAIRMAN. I think your presumption is probably right.

You see, we on this committee for 2 years now have heard the Fed make its short, its medium, and its long term targets on M_1 . And they have been grotesquely wrong for periods of time even back when some members now sitting with this committee were in civilian life.

How long should we wait before we conclude that there should not really be a trout in this can of milk?

Mr. MCKINNEY. Mr. Chairman, what I am saying is that if the Federal Reserve Board said, being mindful of all of the factors in the economy, we are going to make M_1 comply with our targets no matter what else happens, I think there would be a serious danger of going too far. I am, therefore, pleased that in practice they either do one of two things: Use some rule of flexibility with M_1 , or change M_1 .

Now, they have not changed M_1 . That is their decision. Accordingly, I would be for some rule of flexibility. I do not want to see us have a Fed funds rate of $9\frac{1}{2}$ percent, and I think this could happen if they took a week interpretation of M_1 .

The CHAIRMAN. Yes; nobody on this committee has suggested a change. I am sure you are aware, members of this committee, including myself, have suggested that it does harm to domestic and foreign monetary markets to consistently, since April 1977, issue target figures and then grossly exceed them, month after month, quarter by quarter, year by year. How long do we have to wait, decades?

Mr. MCKINNEY. Again, sir, I am in a position here as Chairman of the Bank Board not Chairman of the Federal Reserve Board. I do say they have met M_2 and M_3 . I cannot say what I would do if I were Chairman of the Federal Reserve Board.

One answer, of course, would be what you are suggesting—to increase the M_1 ranges to where ranges can be met. That is, of course, one solution.

I am sure there are those on the Federal Reserve Board who don't want to do that, who believe in a tighter, more restrictive policy. Some of them I think are the same people who gave us the tight, overly restrictive policy of 1973 through 1975. And I don't want to see that again—I don't want to see a prime rate of 12 percent. I do believe in flexibility.

The CHAIRMAN. But you don't think those who have brought disaster upon us are still in the majority of the 12 man, soon to be 11 men and a woman, Open Market Committee?

Mr. MCKINNEY. I have not done a head count, Mr. Chairman, but I am persuaded by the leadership qualities of Mr. Miller as the Chairman, and I don't think he believes that—which makes me glad.

The CHAIRMAN. You think he can change them around?

Mr. MCKINNEY. I think he can. He has shown leadership there already that way, otherwise we would have had higher rates today than we have now, yes, sir.

The CHAIRMAN. My time has expired.

Mr. Mitchell?

Mr. MITCHELL. Thank you. It is good to see you again, Mr. McKinney.

Mr. MCKINNEY. Congressman Mitchell.

Mr. MITCHELL. I must confess it's going to be difficult for me to raise questions. I am somewhat perturbed about the reasons why Secretary Harris will not be here this morning. I hoped we had moved away from that pattern in the White House of heavy censoring of the statements to be made by the various agency heads. It is disturbing to see that development. But I do have a question anyway.

You are not disturbed by that, are you?

Mr. MCKINNEY. By Secretary Harris' not appearing here? I am sorry she is not here, of course.

Mr. MITCHELL. About the censorship.

Mr. MCKINNEY. All I can say to that, Congressman Mitchell, is that I sent them a copy, and I am pleased I head an independent agency.

Mr. MITCHELL. Thank you, Mr. McKinney.

You know, there are two schools of thought with regard to the high interest rates and, of course, the associated high mortgage rate. There are some economists who feel that fast money growth creates inflationary expectations and, therefore, creates high interest rates. There is another school of economic thought that says that if money growth is fast enough and high enough it will provide enough liquidity to drive down interest rates. Now, those are two sharply contradistinctive points of view. Could I hear your comment on which side does your thing fall?

Mr. MCKINNEY. The latter point—that if you drive it up fast enough it will create enough liquidity to bring it down is a theory that I would be a little afraid to try. I think you have to use a rule somewhere in the middle ground.

I guess I believe that, in order to control inflation, you cannot just take control of monetary policy or fiscal policy or the private sector or what have you. You must take into account that they all work together, and, accordingly, approach matters on a broad

front. I think we made the mistake in 1973 through 1975 of having a restrictive monetary policy that was supposed to stop inflation, but what in time in part helped create inflation. It brought rates so high that by themselves they helped to create inflation. So, summarizing, I would like to see an approach that was not quite either one of those you expostulated, but somewhere in the middle, Mr. Congressman.

Mr. MITCHELL. In your testimony you had indicated the possibility of some dire things happening with regard to mortgage rates if certain other things happened. There is a school of thought that says no matter how high interest rates go, people are going to continue to purchase homes because of their fear of inflation in the 1980's.

The assumption is that up to a certain point people will buy big homes primarily to avoid a higher inflation rate 2 years, 3 years, 4 years hence. In light of that, both in your testimony and in my statement, what is your specific forecast for housing starts for the last half of 1978 and 1979?

Mr. MCKINNEY. We have a prediction that housing starts for the entire year of 1978 will average about 1.9 million starts, Mr. Mitchell. That would contemplate, therefore, a slowdown in the third quarter to an annual rate of about 1.95 and a slowdown in the fourth quarter to about 1.8, as I recall the figures. These are higher, I realize, than most economists and other groups have predicted.

We have felt all along that there was a strong housing demand out there, and that, if we could help support it, it would remain strong. We are predicting that next year, as well, there will be a reasonably strong housing market in about the 1.85 million range, which I think is probably again higher than most people predict.

Now, all of this is contingent upon a reasonable interest rates scenario. Of course, what was reasonable 2 years ago and what is reasonable today, as we have all watched, is hard to figure.

There are many who would have said a 12-percent rate would have stopped all mortgage lending, but it has not. I am sorry to have to agree that the concern of this country about inflation is so great, that they are willing to go ahead in spite of these interest rates. The fact is that the public considers a home one of the best investments which, of course, it has proven to be.

But that is my prediction for housing for 1978 and 1979.

Mr. MITCHELL. Do I have time for another question? Are we operating under the 5-minute rule?

The CHAIRMAN. You do.

Mr. MITCHELL. Let me slip just a little bit beyond the scope of this hearing to ask about commitment to inner-city housing. Where are we on this? What proportion of the advances from the bank system go into inner-city savings and loan associations? I am quite interested in whether you are beginning to target at all in terms of inner-city housing and homeownership.

Mr. MCKINNEY. Mr. Mitchell, I know I have talked to you about this already some months ago.

Mr. MITCHELL. Yes; you did.

Mr. MCKINNEY. We have, of course, created what we call a Community Investment Fund. It is a fund of specially priced ad-

vances totaling \$10 billion, which will be drawn down in the amount of \$2 billion a year. That fund is targeted toward community revitalization, particularly in large and small cities. We just started this in July, but we have already made commitments of a little over \$200 million.

Again the funds will be advanced at below market interest rates, and they are targeted specifically for community revitalization of, for example, inner-city areas.

We expect this program to build momentum during the fall and by next year to be running at the projected rate of \$2 billion a year. Since this is being done through the FHL banks it is in a real sense financed by the savings and loans. So, through this program we expect the savings and loans to do a very substantial amount. By the way, these special advances are in addition to our regular advances.

I don't have an exact figure for you on how much of our ordinary advances are going toward inner-city housing. The Community Investment Fund, which we are going to monitor very carefully, will give us a way to see where the funds do go.

Mr. MITCHELL. You are off to a very excellent start, and I would hope that I could be kept posted on the buildup of this development.

Mr. MCKINNEY. Be glad to do that, sir.

Mr. MITCHELL. My time has expired. Thank you.

The CHAIRMAN. Mr. Kelly?

Mr. KELLY. Thank you, Mr. Chairman.

Good morning.

Mr. MCKINNEY. Good morning, Mr. Kelly.

Mr. KELLY. In your testimony you say that savings move inversely with interest rate movements and when the interest rates get too high this tends to draw the money away from the housing market and causes some troubles for that industry.

So that would seem to me to indicate that you feel that increases in interest rates have some impact on the saving public. Is that a fair conclusion?

Mr. MCKINNEY. Yes, sir.

Mr. KELLY. OK. Do we have more capital in the United States for investment in heavy industry and research and development in industry than we need? I mean, is it coming out our ears, and we don't know what to do with it? Do we have so much of it? Is that the situation in our economy?

Mr. MCKINNEY. I don't think so.

Mr. KELLY. I don't, either. I wonder if higher interest rates just generally might start to encourage people to save some money, because as it is now with presently controlled interest rates, people who save money, if they are saving any money at all, are actually losing money. Isn't that so, when you consider the taxes on their interest and the effects of inflation? With current interest rates people are really kind of get ripped off a little bit by putting money in savings and loan associations, aren't they?

Mr. MCKINNEY. Mr. Kelly, the problem is inflation, not the interest rates. We have got to do something about inflation. Basically speaking, for example, in 1976 and 1977 the interest rates paid by savings and loans were above market rates paid elsewhere.

Mr. KELLY. But it is inflation?

Mr. MCKINNEY. Inflation is the problem.

Mr. KELLY. And so I wonder does it help control inflation if you invest in the means of productivity and don't spend quite so much money on consumer items? Doesn't that help control inflation basically?

Mr. MCKINNEY. I would say it did.

Mr. KELLY. And so what you are suggesting is let us stoke the boilers and just everybody build houses and buy them to hedge against inflation, instead of putting the money into the means of research, development, and production, so the United States can get back into its relative position with the rest of the producing nations in the world. I mean, what we should do is just act like that is another world, and we just build houses.

Mr. MCKINNEY. No, sir.

Mr. KELLY. Then I do not understand you.

Mr. MCKINNEY. I will try to be more explicit.

Mr. KELLY. OK; I need a lot of help.

Mr. MCKINNEY. I do, too, at times, sir.

What I am saying to you is that the housing market has suffered disproportionately in every recession we have had recently in this country. When you go from 2.1 million starts to 1.1 million and back up again, the inefficiency, the inequity and the human suffering is just appalling. We have to devise some way to stop that. I consider that my job, and the main task of the Bank Board, is to try to ease some of those troubles.

Now, I don't mean to say to you we ought to create demand for housing. We should watch it very carefully, and our policy should be anticyclical. Our posture now is to try to fill the troughs, and avoid these huge cycles in housing that prove so very disruptive to our entire economy. But that does not mean I disagree with you on the validity of the need for long-term investments.

I think the whole economic structure in this country should be keyed more to creating incentives for long-term investment.

Mr. KELLY. Isn't it a national problem in this whole area about interest rates? You seem to feel as though interest rates are inflationary and that they are a problem. But isn't it just generally a problem that more and more people are being discouraged as a matter of fact from saving money by the present arrangement?

Mr. MCKINNEY. Of course, inflation is a very discouraging event, and when people see that—

Mr. KELLY. I am talking about the Government.

Mr. MCKINNEY. The Government, sir?

Mr. KELLY. I mean, I am taking the position that the Government comes first on a chicken-and-egg routine, that very definitely the Government has a lot to do with inflation.

Mr. MCKINNEY. Oh, it certainly does.

Mr. KELLY. And that they are discouraging people through inflation in several other ways from savings.

Mr. MCKINNEY. They are; that is correct.

Mr. KELLY. To start with, they are taking all of their money and spending it somewhere else, that is a real discouragement to savings.

Mr. MCKINNEY. That is right.

Mr. KELLY. You said at one point that interest rates are higher because of inflationary expectations as opposed to being a cause of future inflation. But at another point you say that the Federal Reserve policies directly determine interest rates, which is correct. In other words, is the Federal Reserve causing interest rates to go up or is inflation doing that?

Mr. MCKINNEY. The Federal Reserve has a direct impact on interest rates and they can set interest rates. As far as the Fed funds rating and what they do in the open market, there is no question that they do affect interest rates, and do so very directly. But as you said, the expectation of inflation also is a problem. For example, a lender in setting rates on his money is going to take into account the fact that if it's a long-term loan, he is going to have an inflation factor in there.

Mr. KELLY. But also the expansion of the money supply has something to do with enhancing the expectations. In other words, if they print and dump all of this money on the economy they can then expect with great apprehension there is going to be inflation because they know very well that is true; isn't that so?

Mr. MCKINNEY. Yes, sir.

Mr. KELLY. OK; so that they can control people's expectations by controlling the supply of money.

Mr. MCKINNEY. To an extent.

Mr. KELLY. All right. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Derrick?

Mr. DERRICK. Thank you, Mr. Chairman.

Mr. Chairman, in your statement on pages 17 and 18, you speak about having had a good year in housing and I think you said you figured it would probably average out to about 1.9 million new starts this year.

Mr. MCKINNEY. Yes, sir, I did.

Mr. DERRICK. My question to you is in view of your statements and I quote, "We are less confident of our ability to maintain the projected level of mortgage lending," and so forth: This is August 7. What does it look like for the fall of 1978, supply and interest-wise?

What has it been running on an annualized basis so far this year, more than 1.9; is that correct?

Mr. MCKINNEY. That is right. It has been running around 2 million units. I don't have the figures here, but close to that. If you recall, there was a severe dip in the earlier part of the year. Many economists at that time were predicting that the housing boom was over. Then there was a substantial rebound in the spring, and the June figures came in very, very good. So that now people realize that there is a strong, steady, demand out there.

The effect of higher interest rates though is bound to have an effect. And we think we are going to see a slowing down in the third quarter to a rate of about 1.85 to 1.9, and then in the third quarter about 1.8, which will make for the year about a 1.9 average.

Mr. DERRICK. And you see the interest rates as remaining about the same, or going up, or what?

Mr. MCKINNEY. The effective mortgage rate in the country—of course, it varies between multifamily and single family, and so on—is running around 9¾. That has many geographic variations,

too as you know. We don't see it going up much more. We think it's near its peak. That, of course, is based upon the fact that we think the Federal Reserve is going to maintain what we think are reasonable policies. If that does not happen, then something else is going to happen in our marketplace.

Mr. DERRICK. I understand. As you may know, we have just completed the second and final budget resolution, which was just reported out of committee last week, and we indicate in there a deficit of around \$42 billion or \$43 billion. It's down about \$17 or \$18 billion from the projection of the President's budget in January of this year.

Secretary Simon, I think, about 10 days ago indicated that we were using about a billion barrels of oil or less—on an annualized basis—now than we were a year ago.

In my opinion, those are two major factors in inflation and, of course, all of that figures into the interest rates. Do you see these as having an effect of lessening the upward pressure on interest rates as well as the availability?

Mr. MCKINNEY. I think they certainly do. I don't know how soon the budget cuts will come on stream for 1979.

Mr. DERRICK. This is fiscal year 1979.

Mr. MCKINNEY. I assume part of that will begin to take effect in the fall. The sooner it does, the more effect it will have. As you know, the Treasury is going to be borrowing very heavily this fall, but what the Congress has done will have a major impact, and I commend the Congress for it.

Mr. DERRICK. We thank you; and, of course, we will be borrowing hopefully about \$17 or \$18 billion less than what was originally anticipated.

Mr. MCKINNEY. Yes; it is going to have a major impact.

Mr. DERRICK. What do you think we might do on this committee that would help the valley-mountain situation we have in the supply of residential mortgage money? It has been that way ever since I can remember. It is up one year and everyone flourishes, and then half of the builders go out of business the next year, and so forth.

Mr. MCKINNEY. As a partial answer to that question I will tell you what the Bank Board has tried to do about it. We see that as one of our primary missions.

We think that the Bank Board perhaps has not taken an aggressive enough role in that area in the past, that when things get tight, it, like many other lenders has pulled in.

We think the mission of the Bank Board, as long as there is a demand out there for housing, is to try to maintain a reasonable flow of funds. One way to do this is by use of the Mortgage Corporation, and through it we have put a lot more money into housing this year. Also, we have planned farther ahead with our advance system. We began early this year, when we saw there would be shortages to store up liquidity, both in our bank system and in the S. & L.'s. This represents a little more financial planning than we think has been done in some years past.

The Congress has been very helpful in giving us the authority to change the deposit mix in savings and loans. As you know, a few years ago savings and loans mostly took in passbook money. Now,

about 70 percent of the funds in savings and loans are certificates from 1 year up to 8 years. This has given strength to the S. & L. liability side.

Our flexibility also has helped a lot. You have given us flexibility of being able to use the jumbo account to go out and bring in large amounts of money at higher rates when funds are short, and, of course, to use the money market certificate, which we have worked on ever since I came into office last summer, and which creates an instrument that should ease somewhat these monetary disruptions. I realize there has been some conflict over whether that is a good idea or a bad idea. I happen to think it is a very good idea. Mr. Derrick, in giving us these powers to carry out what I consider to be our function, I think Congress deserves much credit this year for the fact that although mortgage rates have gone up and savings flows have gone down, housing has stayed even.

Mr. DERRICK. So I might say you have an optimistic outlook for the next 7 or 8 months rather than a pessimistic one; is that correct?

Mr. MCKINNEY. Reasonably. I think that is probably a fair prediction. I think the economy is entering a period of stability. I don't want to see it go down, and I think if the Fed, for example, should tighten up too much in order to control inflation you might see it go the other way. I would not want that to happen.

Mr. DERRICK. I thank you very much.

The CHAIRMAN. Mr. Pattison?

Mr. PATTISON. Thank you, Mr. Chairman.

Mr. McKinney, we in New York are having a real problem right now because there are high interest rates and we have an interest ceiling of 8½ percent and essentially the New York mortgage market has shut down. The only mortgages that are available are with the minimum of 35 percent down and that kind of restriction, and many, many banks and savings institutions have just simply shut their mortgage windows down.

I recognize that is essentially a State problem, we leave it to the States to regulate interest rates if they choose to do so. But it does have a great impact upon housing from a national point of view to the extent that the National Government is in charge of encouraging housing in New York.

Is there Federal action or what is your opinion about that, and do you think that Federal action is called for if the New York State Legislature does not increase that statutory rate?

Mr. MCKINNEY. The pressure on them must be awfully intense to increase that statutory rate.

And therein, of course, lies the problem. The success of our country in the monetary flow of funds has been the fact we do have ability to take funds from capital surplus and move them into capital deficit areas, but you have to get a reasonable return on investment or the whole system breaks down. That is why we have our advance system and, secondarily, mortgage market system and all.

When a State creates an artificial barrier like that, it causes not only a problem for housing but problems for the financial institution as well as in the earnings and the whole financial stability of the system is in trouble.

Mr. PATTISON. Some years ago we enacted special legislation in the Congress that affected primarily Tennessee and Arkansas because they had constitutional debt limits on loans to farms. It also happened to apply to New York, and we said we preempted that essentially. That legislation has since expired because I think Tennessee and Arkansas and New York have all solved that problem internally.

Should we be thinking about doing that now if the New York State Legislature does not act for New York?

Mr. MCKINNEY. Of course, that is a pretty tough question.

Mr. PATTISON. Yes, it sure is.

Mr. MCKINNEY. I am sure you thought it through very carefully coming from New York.

Mr. PATTISON. Aside from the State's rights issue, I mean aside from the politics of it, from a housing point of view, what would your opinion be of that?

Mr. MCKINNEY. Of course, it would help. It would give them the ability to invest their money in New York, and the ability to attract savings. It would be very helpful from the housing point of view. I think that keeps me from addressing the political question.

Mr. PATTISON. I understand. One other question:

For years the savings institutions have maintained their support for the differential between thrifts and commercial banks in what they can pay on savings accounts. Now, we have the linked accounts coming up, automatic transfers which further complicate that.

Do you have an opinion as to whether that differential really does get money to housing or is that effective or is it not effective?

Mr. MCKINNEY. I have a strong opinion on that: Yes, sir; it does. The facts show that banks still far outperform S. & L.'s in the passbook accounts type of area, even though there is a differential. The banks continue to get a larger share of that market. But in the long-term certificates, which the S. & L.'s have been issuing in the last 5 or 6 years, they have been outperforming the banks, and here the differential has been of very great value. These are the funds that have really helped housing.

They have helped to balance the long-term loans with the long-term liabilities; of course I haven't meant to imply that the differential is not needed for passbook savings—the S. & L.'s would be taking an even worse beating in this area without it.

Mr. PATTISON. In New York, where the thrifts, except Federal thrifts, have transaction powers, that has had quite an effect on the phenomenon of the bank's passbook accounts, and there has been an enormous market erosion on the part of the banks. Now, I come from an area where there are still a few small community banks, which do, as a matter of fact, get into financing of residential homes to a great extent, some more than the thrifts, although that is rare, but sometimes they do.

Where they are across the street from a thrift that can offer essentially the same things that people care about in banks, that is a transaction account and a savings account, and now with their ability to link those as of November 1, that has a very severe impact upon those banks, and on their ability to lend for residential housing.

Mr. MCKINNEY. Again, it is a problem primarily found in New York State where you do have a differential in effect on a checking account.

Mr. PATTISON. Yes.

Mr. MCKINNEY. And one could debate the equity of that.

Mr. PATTISON. All right.

Mr. MCKINNEY. One could debate that.

Mr. PATTISON. Thank you.

Mr. MCKINNEY. Right, sir.

The CHAIRMAN. Mrs. Fenwick?

Mrs. FENWICK. Thank you, Mr. Chairman.

I have three questions, if I may state them rapidly, then maybe we can get rapid answers.

One, what effect would it have if we stop artificial ceilings on interest rates?

Two, like Mr. Pattison, I come from an area where the commercial bank may have 70 percent total loan portfolio in mortgage loans and over 80 percent of the deposits in the time deposit category.

Why not even-stein? Why don't we simply say that any bank that reaches a certain proportion of mortgage loans may have the privileges that are accorded to those banks which have whatever proportion the Federal Home Loan Bank Board and the Federal Reserve decide is an equitable proportion?

The third question is how about universal reserve requirements? What would you think of requiring universal reserve requirements as a matter of safety for the public, and giving permission that they be put in income-bearing securities? This would make unnecessary the interest payment the Federal Reserve is contemplating.

Thank you. Those are my three questions.

Mr. MCKINNEY. Thank you for your three simple questions.

Mrs. FENWICK. I know.

Mr. MCKINNEY. I tried to make quick notes and I hope I got the right things down.

You mentioned removing artificial limits on interest rates. Did you mean on the savings side?

Mrs. FENWICK. Yes.

Mr. MCKINNEY. Were you talking about the total rate question and not just about the differential?

Mrs. FENWICK. Just the whole business; what would happen if we simply loaned money at the supply and demand level?

Mr. MCKINNEY. Since we all believe in the free enterprise system, this has a definite appeal to all of us, and I can see how many would say: "Why not do this?" Personally, I think it might be disastrous and I would be unwilling to have it tried during my tenure.

I think what we created in the S. & L.'s was a place for safe, sound savings, but savings not necessarily always yielding the maximum possible rate. We have tried to help savers by creating new types of instruments that are more sensitive to what the market rates are—the money market certificate we now have, for example, which has already brought in some \$9 billion. But we have tried to do this a step at a time.

Mrs. FENWICK. That suggests to me that you had to work against the artificial rate to make it more flexible. Everything you are saying I know is true, and it seems to suggest an opposite conclusion.

Mr. MCKINNEY. It does not reach the opposite conclusion to me but I do see your argument. I think we need to have some flexibility and we are trying to respond to that need. I do think though that the S. & L.'s primarily exist for the safety and soundness of savings. Nevertheless, I am concerned about trying to get the maximum savings rate paid to savers, and sometimes I do feel we pay too much attention to the borrower and not enough to the saver. When we are making judgments in this area at the Bank Board, I always try to take that into account.

But I think to have completely unrestricted interest rates paid on savings, would cause severe problems. In the first place, I don't think the S. & L.'s could compete equally with the commercial banks. I think probably there would be a rate war and we would have a lot of failures. Since I am also the Chairman of the FSLIC, I would not like that to happen. That is a frightening prospect.

Mrs. FENWICK. I would ask you if possible to look at this from the point of view of all the financial institutions, rather than just the S. & L.'s, because our purpose here is not to save or destroy any particular one of the banking systems.

Mr. MCKINNEY. No; but the purpose of Government, it seems to me, is to try to balance competing interests in our society.

Mrs. FENWICK. Exactly.

Mr. MCKINNEY. And we are here trying to balance the interest in having mortgage rates that are somewhat reasonable and available, with having a place of safety and soundness for the savings of the average American. It is my obligation to look at these things from a broad perspective, and to balance matters accordingly.

Mrs. FENWICK. Yes.

Mr. MCKINNEY. Turning to the next question, I believe savings and loans have about 82 percent of all of their loans in residential lending.

Mrs. FENWICK. I wonder about that because we have had in testimony before this committee, indications that the savings and loans, when there was a question of a 60-percent requirement, were very upset.

Mr. MCKINNEY. Mrs. Fenwick, I think you are referring to the mutual savings banks. The 60-percent figure comes from a provision that I asked the Congress to enact that would apply to mutual savings banks seeking Federal charters. The mutual savings banks now have an average of about 55 percent of their funds in housing.

Mrs. FENWICK. Right.

Mr. MCKINNEY. And I thought in order to get Federal charters, they ought to have a higher requirement. So that is where the 60 percent—

Mrs. FENWICK. Suppose you had a commercial bank, with the proportion that you have decided would be the equitable proportion, why should it not enjoy all the privileges of any bank which supports this worthy social cause?

Mr. MCKINNEY. Mrs. Fenwick, we have two or three issues going at once here. If I may go back, savings and loans through the tax

law and through other congressional action have 82 percent or more of all of their savings in residential mortgage loans. These are long-term loans, many of them, as you know, at 5 percent, 6 percent, 7 percent, and so on. Congress has felt that this type of an industry is needed to provide housing for Americans, and that is why today two-thirds of all of the money loaned for housing is by S. & L.'s. But, then, there are mutual savings banks—

Mrs. FENWICK. But suppose another bank, a commercial bank had the same proportion, why should they not do the same thing?

Mr. MCKINNEY. You probably could not argue with that.

Mrs. FENWICK. That would be satisfactory to you?

Mr. MCKINNEY. I would want to give it a little more consideration, but I could see some merit to it. I don't know of many commercial banks that have 82 percent of their funds in residential lending, however.

Mrs. FENWICK. But if they did, you would not be against it?

Mr. MCKINNEY. That is correct. However, I don't think you will have a big ground swell of commercial banks doing that.

Your third question was on reserve requirements. My feelings about reserve requirements are very simple. We now have something similar to that for S. & L.'s—what we call liquidity requirements. As I mentioned, we cut these requirements from 7 percent to 6½ percent just recently. Under the regulation, S. & L.'s have to have that percentage of their total withdrawal accounts and short-term borrowings in liquid assets such as Government bonds. They can earn interest on these assets, and, philosophically, I guess my response to you is I think member banks of the Federal Reserve System also should have the right to have interest on their reserves.

Mrs. FENWICK. Thank you.

My time has expired, I am afraid. Very interesting, thank you.

Mr. MCKINNEY. Thank you.

The CHAIRMAN. Thank you, Mrs. Fenwick.

Mr. Cavanaugh?

Mr. CAVANAUGH. Thank you, Mr. Chairman.

Mr. Chairman, I am sorry I got in late and I have not completed reading your statement, but I will attempt to ask some questions anyway, and if the answers have already been given, then just refer to them.

I am captivated by your initial discussion here of the relationship between the Fed and yourself.

On page 12 you say:

There are a number of long-term policy actions that have been implemented in recent years. These include money market certificates, NOW accounts, early withdrawal penalties and savings certificates, Jumbo certificates and rate ceiling revisions * * *

and so on and so forth.

You say,

Collectively, these changes have affected Federal Reserve monetary policies by making S. & L.'s savings flows less sensitive to rising interest rates. Thus, mortgage lending and housing construction are less susceptible to the adverse effects of rising interest rates, which in turn have reduced the needs for external financing by the bank system.

It seems to me to be a very important statement both for you and for the Fed. It would seem to indicate that the Fed can no longer rely upon its tools to accomplish its goals which are a bumping of the interest rates, for example, bumping of interest rates from time to time in order to discourage market demand.

Would you agree with that?

Mr. MCKINNEY. This does give a little more stability to M_3 and, therefore, a little less flexibility; yes.

Mr. CAVANAUGH. Would you characterize it as an erosion of the Fed's ability to determine monetary policy through the interest rate, through attempts at increase in the interest rates?

Mr. MCKINNEY. From my observation of monetary policy, the main efforts have been in M_1 . I don't see much effect in the M_1 area, and I don't claim to be a great student of M_1 , M_2 , and M_3 , but my reaction would be that this would primarily be effective with regard to M_3 .

Mr. CAVANAUGH. The lessening of the Fed's impact would be?

Mr. MCKINNEY. Yes.

Mr. CAVANAUGH. Would be in M_3 ?

Mr. MCKINNEY. Yes, sir.

Mr. CAVANAUGH. But no significant lessening—

Mr. MCKINNEY. In M_1 , no sir.

Mr. CAVANAUGH. When Chairman Miller testified last week he stated that, and you have a discussion here of the Fed's aggregate targets, he stated that had they met their aggregate target for M_1 in the last three quarters, that he expected that the effect of that would have been zero economic growth.

Have you given any consideration to that, and would you agree with that statement that if M_1 growth had fallen within the ranges of 4 percent to 6 percent over the last three quarters that it would have had an effect of zero economic growth?

Mr. MCKINNEY. I don't have his exact figures, but I would certainly agree that seeing what M_1 did during those three quarters and seeing what the growth was, that it would have had a rather dampening effect if they had contained it within the M_1 projected figures. It would not have been very good for the country.

Mr. CAVANAUGH. Now, the FOMC, in its most recent settings of the targets reset the same targets?

Mr. MCKINNEY. Yes, sir.

Mr. CAVANAUGH. Do you feel that those targets are realistic today in spite of the fact they were not realistic over the last three quarters?

Mr. MCKINNEY. By realistic do you mean that they should meet them exactly on a regular basis?

Mr. CAVANAUGH. I am talking in reference to a projected growth range. Would an M_1 target, of 4 to 6 percent over the next three or four quarters be anticipated to accommodate, what is generally stated as the ideal growth in GNP, a 3- to 4-percent real growth figure, or would it accommodate something less than that?

Mr. MCKINNEY. If we are looking for a 3½- or 4-percent real growth, and an inflation rate of say 7 to 7½ percent, it's obvious it would be very hard to maintain an M_1 target of 4½ to 6 percent.

Mr. CAVANAUGH. So it would be your feeling it is overly restrictive to stay within the given growth goals of 4 to 6 percent for M_1 ?

Mr. McKINNEY. It's a very optimistic goal to meet, certainly.

Mr. CAVANAUGH. Thank you, Mr. Chairman.

I have no further questions.

The CHAIRMAN. Mr. Watkins?

Mr. WATKINS. Thank you, Mr. Chairman.

Mr. McKinney, I am one of those home builders who came to Congress, and I have been reading your testimony with great interest.

Home builders have been the whipping boy for fluctuation of interest rates. I think you point that out in your figures by showing the drops in housing starts in 1966 and again in 1969, and then in the 1973-74 period they really took off.

I think you may be wrong, the 1.9 is optimistic, and as you well know we could probably stand at 2.2 or up to 2.4 to 2.5 starts in this country. So we are way behind what many of us in the building industry have been told we probably could utilize in the market.

I think also when you look at employment, that home building, construction is a great place to offset unemployment which we have done.

Some of us who have gone to mortgage bankers, through FHA housing, are confronted with the interest rates. When it goes up, the points sometimes go down. Then it stays there, stabilizes, then the points jump up, and sometimes get into the 4- to 5-point bracket. To me this is a tremendously inflationary factor because, as builders, when you pay for the points you have to pay it from somewhere.

You have to add it on top of your overall costs in order to try to recover it. Therefore, it's a very inflationary, artificial mechanism of getting money. However, we can go through the mortgage banking route to get a guarantee, to get money above the interest rate when we go in the market.

How can we stabilize this to the point or deviate it enough that we don't have to add all of these points on top?

I know the reason we try to get the money over there in the housing market. Could you help me to clarify how we might go about this, because this 4-percentage points or 5 percentage points on the front is inflationary immediately? If we had it stabilized, maybe with a little bit of a differential like the regulation Q over a long period, I don't think we would find our inflationary jump immediately.

Can you help me on that?

Mr. McKINNEY. Congressman, in the first place, the points are there because of the fact that their interest rate is not market rate. It's an attempt to adjust to market rates. So, one tool would be to have the FHA, VA rates more flexible to market rates.

Another solution, of course, would be to have it paid differently, to have it paid over a period of time so it didn't hit with the impact it does have.

I was not in the home building business, but I was in construction and banking and savings and loan business, and I was familiar with the problems in this area. These points sometimes do get to be enormous, and I agree with you, but it is the marketplace that causes those points, Congressman Watkins and, unless HUD ad-

justs, for example, on a regular basis and keeps it a marketable rate, then you are going to have an artificially high number of points.

Mr. WATKINS. Is there a way we can study how we might put that over a longer period? I know we have to deviate in order to compete in the market. Maybe the interest is lower and maybe we should allow it to adjust to where savings and loans are.

Mr. MCKINNEY. We will be happy to study it. Actually, that would have been a question more appropriate for Secretary Harris, a study, but I will be happy to look at it.

Mr. WATKINS. Can you relay that to her?

Mr. MCKINNEY. Yes; I will be happy to do that.

Mr. WATKINS. The other question concerns inner-city housing, other investments, your community investment program, and the set-aside of \$10 billion for this program.

I am the person who wrote the letter about why I am concerned about small cities and rural communities.

Mr. MCKINNEY. Yes.

Mr. WATKINS. I represent 25 counties. My district runs 300 miles one way and 200 miles the other, and I only have about half a dozen savings and loans in my district. These savings and loans probably have no means of actively participating in serving these hundreds of small communities.

This is not intended, but I am quite sure if you look at the 200 miles, none of those savings and loans are in the small, rural communities because they are limited within the scope of where they can go out and serve.

Therefore, what we have done in many cases, not intentionally, is that we have redlined serving the citizens in small cities and rural communities of this country. I am concerned about this \$10 billion, because I don't think it's going to get to my citizens. For instance, the largest city I have in my entire district is 22,000. Can you tell me how you might be able to help us get more of that money to the small cities and rural communities?

Mr. MCKINNEY. Yes, sir, I would be happy to.

The reason we do not call this an urban investment fund was because we meant what the name says: community investment fund. We have in it some special provisions to try to help smaller communities and to try to help smaller savings and loans. We have more recently gone to a policy that we are discussing to try to help the smaller savings and loans get their share of it more quickly because being smaller, their proportion is smaller in doing the job.

I have taken criticism, frankly, from some of the large cities which say: "Why don't we just target it all for the large cities because their problems are so immense?"

My response to that has been that even though \$10 billion is an awful lot of money, it is not going to cure the problems of our cities. And smaller communities have severe problems, too. Therefore, we are trying to spread it around and do the best job we can.

I can say that we have a definite interest in helping small communities. If there was a misunderstanding, that is not correct. I can assure you, we are going to make an effort in that area.

The CHAIRMAN. Thank you, Mr. Watkins.

Mr. Leach?

Mr. LEACH. Mr. McKinney, having served on a regional Federal Home Loan Bank Board, I sympathize very much with the position you are in. Few industries are more buffeted by inflationary winds. I suspect few jobs are more difficult to come to grips with.

Accordingly, I know a number of us on this committee are very appreciative of the attitude you have taken. Housing in this type of setting is probably the most difficult industry to stabilize.

One of the most talked-about tax initiatives this year has to do with a return of capital gains taxation to a lower rate. Would you comment on whether this action would have positive effects, negative effects, or no effects whatsoever for housing?

Mr. MCKINNEY. Of course, one of the proposals I have read about only in the newspaper, has been the \$100,000 benefit on home sales. That would certainly help individuals in their home sales. It would be hard to say one would be opposed to that.

I don't think your question goes to that, but at some point the question has to go to the fact of what can we cut, and where, and what cut is the most urgent at this time.

Capital gains, I think, have been unfairly hampered. I think changing the laws which had given a special benefit to the building up of assets and the sale of those assets over a long term, to the point where we tax them practically the same as ordinary income, is unfair. I am glad to see a return back to the other way in the minds of Congress.

My only question on that would be timing—whether now is the time or whether we can afford to do that now. How much does that take out of Treasury and how much does it affect our effort to balance the budget? It is obviously a good thing, it is just a question of whether we can afford it at this time.

Mr. LEACH. You would not comment one way or the other whether lowering the capital gains rate would spur housing, or spur industrial development of any nature in terms of construction?

Mr. MCKINNEY. Of course, lowering the capital gains rate will make investment in equities more attractive. It will, therefore, produce more income, spendable income, by the people who are investing in equities, et cetera. I guess my answer to you, Mr. Leach, is that I see it as being helpful, but I don't see it as any big spur to housing, no, sir.

Mr. LEACH. One of the initiatives in this committee is the notion of variable rate mortgages. It strikes me that VRM's have a lot of appeal and I am supportive of that effort.

Mr. MCKINNEY. I am glad to hear that, sir.

Mr. LEACH. Fine, but in doing so, it seems to me you may introduce more competitive factors for the banking industry vis-à-vis the savings and loan industry in that variable rate mortgages will become much more attractive for the commercial banks which have so far stayed out of long-term lending to such a great degree.

Would you comment on that?

Mr. MCKINNEY. I don't think I would agree with that, Mr. Leach. The variable rate mortgage and the Canadian rollover have been used substantially by the commercial banks. The national banks, as you know, are permitted to do this.

One of my arguments for giving this improvement to the savings and loan industry is that they are almost alone in lacking it. Many

State banks can and all national banks can. The more people who make housing loans, the better off housing is.

I don't have any intention of trying to carve out an area for the protection of the savings and loan business. I think the reason S. & L.'s have gotten into housing so much is that it is not more attractive to other investors. The more attractive you can make it to other investors, the better off housing is overall.

Mr. LEACH. Thank you.

The CHAIRMAN. Mr. McKinney you are familiar with the Employment Act of 1946 and its directive to all levels of government to attain the goals of maximum price stability and maximum economic growth?

Mr. MCKINNEY. I am familiar with those overall goals.

The CHAIRMAN. I am talking about the Employment Act of 1946 in which that all started. Those are the goals. They are good goals.

Mr. MCKINNEY. Yes, sir, I can't argue with them.

The CHAIRMAN. I am thus distressed to find that you have inadvertently, I hope, amended the Employment Act of 1946. If you look at page 1, you said in setting monetary policies Chairman Miller and his colleagues on the Federal Open Market Committee and the Federal Reserve Board, must take into account a broad range of economic objectives. These include full employment, amen; price stability, yes sir; economic growth, you bet; and balance of payments.

Now you are giving that freebie to the Fed which is, in my opinion, most unfortunate because the Fed, from time to time, and indeed as recently as last January, does the most misguided things under the cloak of helping our balance of payments.

For example, last January, the Fed deliberately raised interest rates with the thought that because our balance of payments was poor, and it sure is, this would lure foreign capital over here by reason of a slightly higher interest rate. They laid off before too much harm was done.

But certainly one of the reasons that the year-to-year increase on the average effective conventional mortgage rate on new homes has grown from 8.98 percent last year to 9.46 percent this year, I would think, is the Fed's dabbling with balance-of-payments effects. Surely, everyone would agree, that consistent with following the goals maximum production, maximum price stability, maximum economic growth of the Employment Act of 1946, the Fed should take into account balance of payments, so that, if there are two alternate courses, both of which serve equally the aims of the economy, they tend to take the one that helps the balance of payments, too.

Are you really suggesting that you want the Federal Reserve to raise domestic interest rates and make the housing industry, which already faces grave interest rate problems, worse in the hope that they are going to lure a few dollars over here as if life were as simple as that, and, as if the more probable effect is to create a recession at home which will send those and countless other dollars scampering back overseas.

I say this because there lurks, among the 12 of the Open Market Committee, those who actually believe this nonsense. Are you giving them a license to practice it?

Mr. MCKINNEY. No, sir.

Of course, whatever I say here probably wouldn't confer too valid a license in any event, but what I meant was simply that they do have that power. I was openly critical of what they did in January. Of course, they could raise rates today another point or two and thereby change the dollar problem immediately. It would be very unwise, but I am saying they could do that. That is all I meant.

The CHAIRMAN. If they have to raise rates to fight inflation and do it in a way that is consistent with our other goals, the Fed will have no stauncher defender than I. But, are you prepared to say, as I think you are, that the balance-of-payments goals are not either mandated by the basic act of 1946 or permissible when their effect is to lose jobs here and cause housing that would otherwise be built not to be built?

Mr. MCKINNEY. It seems like the balance-of-payments question should be decided through other methods than through raising interest rates. I would agree with you on that.

The CHAIRMAN. Thank you very much.

Let me then conclude my questioning by congratulating you on the job that you are doing. We think you have been very conscientious and forthcoming with this committee.

Mr. MCKINNEY. I have enjoyed being here.

Thank you very much.

The CHAIRMAN. That doesn't end the questioning, however.

Mrs. Fenwick?

Mrs. FENWICK. Thank you.

I would say, wouldn't you, that the housing industry and employment in the housing industry must be in almost record good shape if there are going to be around 2 million starts this year? So we don't have to worry about the employment angle.

Frankly, I have been worried on this committee that some of our housing bills have been employment bills, rather than banking bills. I think that our first priority, if we are doing a housing bill, ought to be housing.

But I would like to ask you a little bit about this variable rate mortgage. I voted for it once and I was very sorry that I did. I tend to like reverse mortgages and all that whole field.

I would very much like to hear your opinion of reverse mortgages. I asked a man who was chairman of the finance committee of one of our biggest insurance companies about his opinion of variable rate mortgages. He said, "They are fine for the people who know how to play around with money and have resources in case of a pinch; but," he said, "I would never suggest them for simple people who want to know what they are going to have to pay and haven't got that extra cushion with which to meet the raises." That was his opinion.

It has greatly influenced my thinking because it seems to me that it is such an appealing thing. Some people are in favor of variable rate mortgages on the basis that the public ought to have a choice. It seems to me that it is like giving people a choice between heroin and aspirin. It is quite appealing to start with, but it puts them in jeopardy for the future.

What do you think of reverse mortgages?

Mr. MCKINNEY. Did you want me to comment on variable rate mortgages, too?

Mrs. FENWICK. If there is time, I would love it; yes.

Mr. MCKINNEY. The way I see the variable rate mortgage is this: The Bank Board is not saying to the country that everybody ought to have one. What we are saying is that many States now authorize them, and in fact, they are being offered regularly in many States. And national banks are issuing them. There ought to be a method whereby consumers are protected on a rational, regular basis; there ought to be a national policy on this issue.

Mrs. FENWICK. Wouldn't it be better policy not to have it?

Mr. MCKINNEY. But it is a fact that they exist. They are not going to go away.

Mrs. FENWICK. Let's outlaw them. How about that?

Mr. MCKINNEY. The States are now authorizing them. I assume we are going to let the States continue to run their own business. Assuming that we will do that, then we need a national policy, I think, to provide leadership here and to set up basic standards. That is what I am talking about.

Mrs. FENWICK. Are they desirable in your opinion?

Mr. MCKINNEY. Properly used, I think they are; yes, ma'am. I think they need proper controls, proper indexing, and proper consumer safeguards. Under those conditions I think they are very desirable as long as it is totally optional on the part of the home buyer. Many buyers, I assume, will gain. I assume the borrower will be offered other benefits to induce acceptance of the VRM.

Mrs. FENWICK. What are the benefits?

Mr. MCKINNEY. Under our proposed regulations there is no prepayment penalty, for example. In many areas of the country mortgages no longer run 20 or 25 years, they run an average of 5 years. The prepayment penalties can be immense on the sale of a house.

Mrs. FENWICK. Couldn't we eliminate it without the VRM?

Mr. MCKINNEY. Again, we would be interfering with State law. These laws are on the books of the various States. So I am dealing with the problems that are here today.

Mrs. FENWICK. But I am saying, is it so bad a problem that we should deal with it nationally?

Mr. MCKINNEY. I think we need to have a national policy in areas like this. As Chairman of the Bank Board, I think it is my obligation when I see variable rate mortgages, and the way they are around the country, varying from State to State, and surrounded with few consumer safeguards, being offered by national banks as well, I think then I have an obligation on behalf of the Bank Board to come forth with a scheme for Federal savings and loans that would give them appropriate VRM powers—subject to consumer safeguards and which would set and example.

I think it is important that I do that and that is what I have done. I think to have a national scheme to protect consumers is important, and I feel our regulations could prove a model in that regard.

Mrs. FENWICK. I can see you and I won't meet on this because my feeling is that even if it is widespread, if it is wrong, we ought to do something about it. We can't just say because it exists we have to accept it. I don't think that is what government is meant to

do, just accommodate itself to evils because they are there and mitigate them as far as possible.

I think the obligation of government is to make things just and equitable and not just mitigate an evil by making it a little less bad.

Mr. MCKINNEY. I think I need more time to explain this and I think if I have the time, maybe we will come closer to the same point.

Mrs. FENWICK. I am sure we would.

Tell me about reverse mortgages.

Mr. MCKINNEY. They are called reverse annuity mortgages. They have a great application for the homeowner who has built up equity in his house. I think the demand for them will be reasonable, but not overwhelming. I think the RAM is a good idea. It is part of Mr. Annunzio's bill.

Mrs. FENWICK. The one I don't like provides that the homeowner borrows an enormous sum from the bank. The bank then buys an annuity for the homeowner and most of the money goes to the bank. The poor homeowner gets a pittance of what is left.

I wish, in other words, that we could arrange not to buy an annuity but simply arrange with the bank a certain payment per year and "you can have the house when I am done."

Mr. MCKINNEY. Of course, that is what some banks would do. That is again why it is important, Mrs. Fenwick, that the Bank Board set national standards for the protection of the consumer in all these areas.

Mrs. FENWICK. I agree.

Mr. MCKINNEY. That is why I hope you will support the Bank Board's proposed regulations.

Mrs. FENWICK. Thank you.

The CHAIRMAN. Thank you, again, Mr. McKinney. We appreciate your contribution to these hearings.

Mr. WATKINS. Mr. McKinney, I will make this brief. I am interested in the community investment program. If you or one of your staff members could give me an appointment, I would like to visit with them about it.

Mr. MCKINNEY. They will be right over.

Mr. WATKINS. I would like to break down the \$200 million by size of towns. I would just like to update myself.

Mr. MCKINNEY. I will be very happy to. I will keep you up to date as we go through the program.

The CHAIRMAN. Thank you.

We now stand in adjournment.

[Whereupon, at 11:33 a.m., the committee adjourned.]

